IN THE

Supreme Court of the United States

October Term, 1974

No. 74-74-157

UNITED HOUSING FOUNDATION, INC. *et al.*,
Petitioners,

v.

MILTON FORMAN and ELLEN FORMAN, *et al.*,
Respondents,

and

THE STATE OF NEW YORK and the
NEW YORK STATE HOUSING FINANCE AGENCY,
Additional Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners United Housing Foundation, Inc., Community Services, Inc., Harold Ostroff, Robert Szold, Milton Altman, George Schecter, Anthony Marino, Paul Kramer, Irving Alter and Julius Goldberg respectfully pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, which reversed a judgment of the United States District Court for the Southern District of New York.*

In addition to Milton and Ellen Forman, the respondents are Earle and Patricia McField; Michael and Phyllis Sicilian; Jack and Diane R. Blackin; Carl and Alma Trost; Robert and Pauline

[*footnote continued on next page*]

In an unprecedented decision, the Second Circuit has held that a membership in a nonprofit cooperative housing corporation which is state-financed and regulated, and with respect to which profit incentives are totally absent, is a "security," as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934. In rendering that startling decision, the Court of Appeals has superimposed federal jurisdiction and regulation upon an already complex state social welfare program available exclusively to low and middle income residents of the state. At the same time, it has geometrically expanded federal securities law jurisdiction to include residential interests in all cooperative and condominium housing.

The decision promises to have a staggering impact on the growing number of government sponsored low and middle income housing programs. It has (i) construed the statutes at issue in a manner expressly rejected by other Circuit Courts; (ii) without Congressional sanction, created an entirely new class of federal litigants by applying statutes enacted to regulate conduct in the investment marketplace to the sales and purchase of residences; (iii) undermined the definition of an "investment contract" estab-

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Carrington; Gilbert and Gloria Narins; Murray and Helene Victor; Jerome and Leonore Baer; Harold Asnin; Joseph S. and Wanda D. O'Connor; Abraham and Irene Kopolsky; Richard Ferguson; Hyman and Beatrice Fertel; Herman and Myra Ackerman; Bernard and Victoria Seinfeld; Frank and Hilda Glassman; Walter Simon; Thomas D. and Elsa A. MacLean; Melvyn and Gloria Plotzker; Gary and Charlotte Stern; Max and Bettina Schwarzhaupt; Herman B. and Rose Goldberg; Stephen and Juanita Reynolds; Arthur and Gertrude Lucker; Abraham and Henriette Schenck; Reginald and Zenobia Thomas; John, Jr., and Elissa Pyatt; Albert L. and Rhoda Abrams; Jack and Pearl Handschuh, individually and on behalf of themselves and all others similarly situated, and in the right of Riverbay Corporation.

lished by this Court nearly thirty years ago; and (iv) created troublesome conflicts with published guidelines of the Securities and Exchange Commission.

Opinions Below

The opinion of the Court of Appeals is not yet reported and is set forth in Appendix A.* The opinion of the District Court is reported at 366 F.Supp. 1117 (S.D.N.Y. 1973) and is set forth in Appendix B.

Jurisdiction of This Court

The judgment sought to be reviewed was entered on June 12, 1974 and is set forth in Appendix C. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Question Presented

Is a membership in a cooperative housing corporation, to which neither the promise, the expectation nor the possibility of profit attaches, a "security" within the ambit of the Securities Act of 1933 and the Securities and Exchange Act of 1934, particularly when it arises out of the following circumstances:

1. A state legislature determines, as a matter of social policy, to take state action to remedy a serious housing shortage for low and middle income groups, and adopts legislation to encourage the construction of low and middle income housing by furnishing substantial subsidies;

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* References to the appendices are prefaced with the appendix letter followed by the page number, *e.g.* (A15).

2. Under that legislation, a nonprofit foundation composed of labor unions, housing cooperatives and civic groups sponsors a massive nonprofit cooperative housing development, the planning, construction and initial management of which is pervasively controlled by the state in accordance with the statutory scheme;

3. Membership in the cooperative corporation

(a) is purchased solely in order to secure a personal residence;

(b) is accompanied neither by promise of profit by the seller nor expectation of profit by the buyer;

(c) can be resold only when the member moves out and only for exactly the price paid; and

(d) is evidenced by two instruments: (i) a lease entitling the member to occupy a specific apartment, and (ii) a certificate called "stock" which reflects the member's participation in the residential cooperative corporation?

Statutes and Rule Involved

This case involves Sections 17(a) and 22(a) of the Securities Act of 1933, 15 U.S.C. §§77q(a) and 77v(a); Sections 10(b) and 27 of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b) and 78aa; and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, the texts of which are set forth in pertinent part in Appendix D.

Statement of the Case

Co-op City, the largest cooperative housing development in the United States, is a low and middle income project financed and built between 1965 and 1972 under New York's

pioneering Private Housing Finance Law (the "Housing Law").* The project was made possible through substantial government subsidies, primarily in the form of low interest mortgage loans provided by the New York State Housing Finance Agency and real estate tax abatements provided by the City of New York.**

The respondents, plaintiffs below, are 57 residents of Co-op City.† They have sued representatively in behalf of the resident-owners of all of Co-op City's 15,372 apartments, and derivatively in behalf of Riverbay Corporation, a nonprofit, mutual housing company organized under the Housing Law to own and operate Co-op City.

Respondents instituted this action against the petitioners (and additional respondents the State of New York and the New York State Housing Finance Agency) in the United States District Court for the Southern District of New York, seeking reduction of their monthly rentals or "carrying charges," money damages and other relief. Federal jurisdiction was based on two claims alleging violations of the federal securities laws. In essence, the complaint charges that "Information Bulletins" distributed to prospective cooperative members misstated and omitted

* N. Y. Private Housing Finance Law §§10-59. Unless otherwise indicated, the facts recited are those found by the District Court as set forth in its opinion. That opinion is printed in full in Appendix B hereto.

** See Housing Law §§11-a(2-a), 22, 33.

† Additional respondents the State of New York and the New York State Housing Finance Agency were defendants-appellees below, and are named as respondents herein only because their motion for reargument is still *sub judice* in the Court of Appeals. Should that motion be denied, we are advised that they intend promptly to file a petition for a writ of certiorari with this Court.

material facts with respect to construction costs and monthly carrying charges which members of the cooperative would be required to pay. Additionally, ten state-law claims are joined in the complaint under the doctrine of pendent jurisdiction.*

Petitioner United Housing Foundation, Inc. ("UHF"), the sponsor of the Co-op City project, is a nonprofit corporation composed of labor unions, housing cooperatives and other civic groups. It is widely regarded as a leader and pioneer in the development of "consumer-oriented housing cooperatives."** Petitioner Community Services, Inc. ("CSI"), is the "service arm"—the general contractor and sales agent—of UHF. Organized under New York's Business Corporation Law, it is a wholly-owned subsidiary of UHF. The individual petitioners are some of the officers and directors of UHF, CSI and Riverbay.

Additional respondent The New York State Housing Finance Agency ("Agency") is a corporate governmental agency of the State.† It furnished a long-term, low interest mortgage loan to Riverbay Corporation financed through a public issue of tax exempt bonds. Additional respondent The State of New York ("State"), through its Division of Housing and Community Renewal, has supervised and controlled virtually every aspect of the planning, construction, promotion and operation of Co-op City.

* An additional federal claim was asserted under the Civil Rights Act, 42 U.S.C. §1983, and 28 U.S.C. §§1331, 1343, solely against the New York State Housing Finance Agency.

** *Cf.* Building The American City, Report of Natl. Commn. on Urban Problems to Congress and the President, H.R. Doc. 91-34, 91st Cong. 1st Sess. 136-39 (1968).

† Housing Law §43(1).

The Cooperative Memberships

Like thousands of housing cooperatives in the United States, Co-op City is organized as a corporation (Riverbay), but for a public, not a private purpose. Riverbay's cooperative members subscribe to instruments formally denominated "stock," but those instruments, in essence, bear little similarity to conventional stock and other forms of securities found in the investment and business communities.

1. Cooperative members purchase their "stock" (at the rate of $450 per room) *solely* in order to enjoy the right to occupy a Co-op City apartment. All of their rights and obligations as occupants are set forth in occupancy agreements (leases) entered into at the time of purchase. The acquisition of "stock," which does not provide the possibility of dividends or appreciation in value, is incidental. It has no independent significance or meaning.

2. Cooperative members can sell their "stock" only when they vacate their apartments and only for the price they have originally paid.

3. All those who have asked to withdraw from the cooperative, whether prior to or after occupancy of their apartments, have done so, and have received refund of their purchase price in full.

4. The cooperative members are the beneficiaries of substantial State and City subsidies designed to reduce the monthly costs of occupancy to below-market levels. These subsidies are in the form of long-term, low-interest mortgage loans from the Agency covering more than 90% of the project cost, and a real estate tax abatement from

the City of New York which reduces the annual taxes which would otherwise be assessed against the project by approximately 80%.

5. Eligibility for cooperative membership is limited by law to low and middle income persons. The prospective cooperative members are fully advised that the cooperative is a nonprofit mutual housing company organized under the provisions of the Housing Law, and will not earn any profits or pay them any income. They are not induced to purchase by any promise of, nor do they expect any, profit, gain or other financial reward.

6. Phrases commonly used in promoting sales of securities or other investments are conspicuously absent from the bulletins and other documents furnished to prospective members.*

Proceedings Below

Petitioners moved in the District Court, prior to answer, for an order pursuant to F.R.C.P. 12(b)(1) dismissing the complaint for lack of subject matter jurisdiction, on the ground that the cooperative interests purchased by the

* In their place are descriptions such as the following:

"The purpose of a cooperative is to provide home ownership not just apartments to rent. The community is designed to provide a favorable environment for family and community living. If you have lived in a private apartment house you were the tenant and someone else the landlord. The landlord's interest was in financial gain. There was no common interest between the tenants. You may have lived in the same apartment for years without getting to know your neighbors.

"The common bond of collective ownership which you share makes living in a cooperative different. It is a community of neighbors. Home ownership, common interests and the community atmosphere make living in a cooperative like living in a small town." p. 166a of Appendix in Court below.

respondents were not "securities" within the meaning of the federal securities laws.*

The District Court granted the motion and dismissed the complaint in its entirety. Initially finding that the mere label "stock" is not determinative of whether an instrument is a "security,"** the Court held that the "essential characteristics" of Co-op City's unusual shares made them something other than conventional stock. The District Court also held that, because of their fundamental nonprofit nature, Riverbay's cooperative shares were not "investment contracts" as defined by federal law.† On this point, the District Court noted:

> ". . . none of the documents involved in this transaction . . . ever, once use material, tangible profits as an inducement . . . [and] it is clear that the Co-op City residents did not purchase the shares with any expectation of profits, as the word is generally used in commerce. These shares are incapable—by law and by-law—of producing any monetary or fungible return." (B21-22)

And, with respect to respondents' argument that the cooperative members' expectations of below-market housing costs furnished the "profit" motive necessary to bring

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* That motion was joined in by the State and Agency, which also raised the issue of sovereign immunity.

** "[T]his Court must, at a minimum, look through the name of an instrument to its essential characteristics . . ." (B17).

† Both Courts below relied upon the definition of "investment contract" set forth in *S.E.C.* v. *W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946), namely, ". . . a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."

the transactions within the scope of federal law, the District Court held:

> ". . . it seems certain that Congress never intended to stretch the scope of the securities acts outside the commercial world and its fungible values, to the uncharted and unchartable realm of intangible, elusive personal valuables where one man's balm may very well be another's bane.
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> * * *
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> "Congress did not intend to sweep into the ambit of the federal securities laws, state-encouraged, nonprofit transactions made pursuant to a state emergency housing law and available only to state residents . . . ." (B26-28).

In short, the District Court held that Co-op City—a public welfare program and not an investment venture—was wholly outside the scope of the federal securities laws. (B28).

The Court of Appeals reversed. Adopting a "literal approach," it held that—regardless of context or purpose—any instrument which is labelled "stock" is within the coverage of the securities laws. It alternatively held that Riverbay shares were "investment contracts." While it conceded that "there is no possible profit on a resale of the stock," the Court found elements of "profit" of a type never before considered in any of the cases decided under the federal securities laws: it held that Co-op City's shares offer the possibility of "profit" to its members because (a) income from leased commercial space might reduce cooperative members' monthly rentals;* (b) personal income

* This includes the leasing of professional offices and retail establishments such as grocery stores; renting parking spaces; and income from laundry room facilities. The figures cited by the Court

[*footnote continued on next page*]

tax deductions of mortgage interest payments and real estate taxes may be taken by cooperative members; and (c) Co-op City housing costs substantially less than equivalent housing on the open market.

Accordingly, the Court of Appeals remanded the case to the District Court as to all defendants and held that the shares of this nonprofit, government subsidized and regulated cooperative housing project were "securities" within the meaning of the federal securities laws.**

Reasons for Granting Certiorari

1. The Court of Appeals' unprecedented decision raises issues of urgent national importance. The decision will affect hundreds of thousands of government regulated cooperative apartments throughout the nation as well as state and local programs designed to stimulate such housing. It will have a direct and substantial impact on all group-owned housing units—both cooperative and condominium (numbering in the millions). It extends federal jurisdiction into a wholly new field and creates a substantial new class of federal litigants without congressional sanction.

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of Appeals (A16) are gross, not net, figures, and do not reflect the costs of maintaining these facilities. Moreover, it is undisputed that Co-op City's incidental commercial facilities were constructed solely in order to service Co-op City's enormous population. Indeed, under the Housing Law, the construction of commercial facilities in a cooperative project is limited to those which are "incidental and appurtenant" to the project. Housing Law §12(5).

** Only four weeks later, the Court of Appeals relied on the instant decision in holding that shares in a privately owned "Park Avenue" residential cooperative were securities within the meaning of the federal securities laws. *1050 Tenants Corp.* v. *Jakobson*, No. 74-1023 (2d Cir. July 8, 1974).

2. The decision is contrary to the purpose and intent of the statutes and conflicts with the decisions of other Courts of Appeals, which have rejected literal application of the definitional sections of the 1933 and 1934 Acts adopted by the Court in this case.

3. The decision undermines the well-established definition of "investment contract" settled in three decisions of this Court,* as well as in scores of Circuit Court decisions, all of which held that the inducement and expectation of "profit," as that word is generally used in commerce, is an indispensable element of every "investment contract" subject to the federal securities laws.

4. The Court's expansive definition of "profit" necessary to the existence of an "investment contract," to include the hope of realizing a saving in living expenses, conflicts with guidelines promulgated by the Securities and Exchange Commission in connection with condominiums and cooperatives. Moreover, that definition is fundamentally unsound and will inevitably lead lower courts farther afield from the kinds of instruments intended to be covered by the securities laws.

I. The question whether residents' interests in housing cooperatives and condominiums are "securities" under the 1933 Securities Act and the 1934 Securities Exchange Act is an important question of federal law which has not been, and should be, settled by this Court.

The decision below does not rest on narrow grounds, applicable only to a government-subsidized and regulated housing cooperative such as Co-op City. It is a sweeping

SEC v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *SEC* v. *W.J. Howey Co., supra; Tcherepnin* v. *Knight*, 389 U.S. 332 (1967).

decision (a) applicable to all housing cooperatives, and (b) apparently applicable to all residential condominiums and other forms of jointly owned housing as well. It has evoked considerable comment, attention and criticism in the legal profession.* Review by this Court is called for because of the striking impact the decision will have on the nation's housing as well as on the federal judiciary and the administration of the federal securities laws.

The Scope of the Decision

This is the first decision, as far as we can discover, in which transactions by resident owners in the purchase or sale of residences have been held subject to suit in federal courts under the federal securities laws. Its impact will be immediate and sweeping.

It will subject to the federal securities laws transactions in the shares of hundreds of thousands of existing government-subsidized or supported cooperatives. These include cooperatives built or converted under the National Housing Act, §§213, 221(d)(3), 221(j) and 236, and defense housing under the Lanham Act, 42 U.S.C. §§1521 *et seq.* It includes approximately 100,000 cooperative residences in New York State alone built or converted under City and State subsidized programs. In addition, cooperative housing develop-

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* Mortgage & Real Estate Executives Rep., Vol. 7, No. 10, p. 1 (7/15/74); CCH Fed. Sec. L. Rep., No. 539, p. 2 (6/19/74); 43 U.S.L.W. 2004; 171 N.Y.L.J. No. 115, p. 1 (6/14/74); Frome, "Buying & Selling Securities: Cooperative Apartments and the Securities Laws" 172 N.Y.L.J. No. 1, p. 1 (7/1/74) and 172 N.Y. L.J. No. 25, p. 1 (8/5/74); 2 Housing & Dev. Rep. 110: P-H Sec. Reg. Guide, Sec. Reg. Rep. Bulletin, Vol. 40, No. 1, p. 2 (12/27/73, commenting on District Court decision).

ments built pursuant to housing programs adopted by other states will be affected. Some states having such programs are: Illinois (Ill. Ann. Stat. ch. 67-½, §§1 *et seq.*, 153 *et seq.*); Massachusetts (Mass. Gen. L. ch. 23A App., §§1-1 *et seq.*); Michigan (Mich. Stat. Ann. §§16.114 *et seq.*); New Jersey (N.J. Stat. Ann. §§55:14J-1 *et seq.*); Pennsylvania (35 Penn. Stat. Ann. §§1680.101 *et seq.*). The decision, moreover, is not limited to government sponsored, financed and/or regulated housing cooperatives. It applies to all private cooperatives.* Furthermore, although the decision does not mention condominium developments, the Court's reasons for holding that membership in a housing cooperative is an "investment contract" and therefore a "security" apply equally to condominiums.**

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* This was made clear in the recent decision in *1050 Tenants Corp.* v. *Jakobson, supra,* in which the Second Circuit held shares in a private cooperative "securities" principally on the authority of this decision.

** The elements of "profit" found determinative by the Court below are present to exactly the same extent and degree in condominiums:

a. The owners of condominium units are entitled to personal income tax deductions for real estate taxes and mortgage interest payments;

b. The owners of condominium units may find some of their expenses offset by income from rental of offices, stores or garages; and

c. The owners of condominium units may enjoy "below market housing costs" if their development receives government subsidies, as in the case of Co-op City, or alternatively, they may simply seek "optimum services at the lowest possible cost," if, as in the case of *1050 Park Avenue,* their development does not receive subsidies.

It is estimated that there are presently over two million residential housing condominium units in the United States. Heckman, Misplaced Criticism Threatens 'Condos,' New York Times, July 21, 1974, §8 at 1.

The Impact of the Decision

The impact of this decision to extend blanket application of the securities laws to purchases and sales of all group owned residential housing units—numbering in the millions —promises to be enormous.

1. The most significant impact will be felt by government subsidized and regulated cooperatives, such as Co-op City. Federal, state and local governments are responding to the critical need for low and middle income housing with innovative programs to encourage cooperative housing developments as alternatives to the traditional—and often unsuccessful—public housing project.* Clearly, however, the costs and uncertainties inherent in adding the web of federal securities laws to the already intricate network of applicable state laws and regulations in the area of government-subsidized housing will create a substantial impediment to further progress in this important field of national concern.** And, as in this case, application of the

* See Building the American City, *supra* at 141-142; S. Rep. No. 93-693, 93d Cong. 2d Sess. 38 (1974). And see Housing Law §11-a(2a), finding by the New York Legislature that cooperative ownership, with its "consequent pride and responsibility of ownership," would improve the quality of urban, "slum ghetto" life.

** Under the Housing Law, virtually every aspect of a cooperative's development and operation is regulated by the state (B6-7). The Commissioner of Housing has broad investigatory and hearing powers with respect to supervision of a cooperative's affairs. Housing Law §32(5). He may remove and replace a project's directors if they have violated the law, state regulations or a cooperative's certificate of incorporation, among others; he may also sue to enjoin such violations—or any act or omission "which is improvident or prejudicial to the interest of . . . the tenants . . . ." Housing Law §32(6)-(7).

In addition to the powers conferred on the Commissioner under the Housing Law, the State Attorney General can sanction and enjoin improper conduct. *People* v. *Cadplaz Sponsors,* 69 Misc. 2d 417 (Sup. Ct. N.Y. Co. 1972). Moreover, the matter of the increased Co-op City carrying charges has been litigated by some residents under available state court procedures. The state court found that the increases were reasonable and mandated by state law. *Hanks* v. *Urstadt,* 37 A.D.2d 1064 (1st Dep't 1971) (Mem.).

federal securities laws to state governments and state agencies, as defendants in the federal courts, raises serious questions of constitutional immunity and other related issues.*

2. Lawsuits arising out of disputes between purchasers and sellers of these residential interests will now be maintainable in federal courts without regard to amount in controversy, diversity of citizenship or the existence of a federal question. This not only includes actions arising out of initial offerings, but any actions arising out of privately negotiated resales, if the telephone or mails were utilized.**

3. Uncertainty as to whether or not registration statements must be filed will be heightened. This is particularly true for cooperative and condominium builders who have heretofore relied on Securities Act Release No. 33-5347 (D5-11) as their guideline for determining whether their units are "securities" requiring registration. Because the Court of Appeals' definition of "profit" conflicts with the definition of "profit" set forth in that Release, the question of registration has become hopelessly confused.

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* The State and the Agency claimed immunity from suit in the federal courts under the Eleventh Amendment to the U. S. Constitution, and also claimed that they are not "persons" within the meaning of the 1934 Act.

** Moreover, it is to be expected that prospective plaintiffs who have even the slimmest chance of establishing a 10b-5 claim will sue in federal court and assert all of their other claims under the doctrine of pendent jurisdiction—a practice which was followed in this very case and which in earlier cases has generated criticism from the courts. *Ryan* v. *J. Walter Thompson Co.*, 453 F.2d 444, 445 (2d Cir. 1971), *cert. den.* 406 U.S. 907 (1972); *Kavit* v. *A. L. Stamm & Co.*, 491 F.2d 1176, 1178-79 (2d Cir. 1974). And, because of the rule established in *Wilko* v. *Swan*, 346 U.S. 427 (1953), agreements to arbitrate disputes arising out of the purchase or sale of cooperative or condominium residences will not be enforceable, thus adding to the prospective burden of federal court litigation that might be expected and further upsetting a traditional and encouraged manner of resolving such disputes.

II. The literal statutory construction adopted by the Court of Appeals defies congressional intent and conflicts with the decisions of other Courts of Appeals.

The decision below—which applies statutes designed to regulate transactions in the marketplace for investment and speculation to personal transactions involving purchases and sales of homes—is fundamentally inconsistent with the purpose and intent of the federal securities laws. Residential interests in housing cooperatives and condominiums are purchased primarily—and in the case of Co-op City exclusively—for use as personal residences. They are not sold or purchased for income or profit. They are not sold or purchased for speculative purposes.

The Court of Appeals, however, held that the use of the word "stock" in transactions in Co-op City cooperative memberships was sufficient to bring these transactions within the ambit of the federal securities laws:

> "* * * [T]he fact that 'stock' certificates are used in a 'stock' corporation is sufficient in itself to bring transactions in the 'stock' within the literal definition of the Acts." (A11).

This literal construction of the definition of "securities" covered by the 1933 and 1934 Acts is not only manifestly wrong, it defies common sense. It produces the anomalous result of extending the securities laws to a state supported and regulated, nonprofit public welfare housing program remote from the world of investment and speculation.

There is no need here to recite at length the well-known and often quoted legislative history of the 1933 and 1934 Acts. Their goals were to regulate conduct and instruments used in the investment marketplace. They sought

to curb unhealthy business practices—including excessive speculation and market manipulation—which had helped to precipitate the financial crises resulting in the depression.*

The statutes were not intended to apply to sales or purchases of residences. And they were not intended to be applied woodenly, without regard to context or economic reality. Indeed, the definitional sections of the statutes (which specifically enumerate various forms of "securities," including "stock," "bond," "debenture," etc.) are prefaced by the words "unless the context otherwise requires," thus suggesting that the context in which an instrument arises must be examined and that the context may not warrant a literal application of the words of the statutes. And, in *Tcherepnin* v. *Knight, supra,* this Court warned:

> ". . . [I]n searching for the meaning and scope of the word 'security' . . ., form should be disregarded for substance and the emphasis should be on economic reality . . ."** 389 U.S. at 336 (citation omitted).

Since "the context" of the instrument in question is of material significance (as evidenced in the statutes) and since "economic reality" is to govern (as stated by this Court in *Tcherepnin*), then the mechanical application of

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* See generally H.R. Rep. No. 1383, 73rd Cong. 2d Sess. (1934); S. Rep. No. 792, 73rd Cong., 2d Sess. (1934).

** This Court has long spoken out against the literal application of statutory language. *Church of the Holy Trinity* v. *United States,* 143 U.S. 457, 458-59 (1892) ("a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers"); *CAB* v. *Delta Air Lines, Inc.,* 367 U.S. 316, 328 (1961), quoting Cook, *Logical and Legal Bases of the Conflict of Laws* ("[Literalism] has all the tenacity of original sin and must constantly be guarded against." In *Cabell* v. *Markham,* 148 F.2d 737, 739 (2d Cir. 1945), *aff'd* 326 U.S. 404 (1945), Judge Learned Hand wisely remarked that it is error "to make a fortress out of the dictionary."

the statutory language in this case was manifest error, particularly when its result is to extend federal law to a wholly new subject area which Congress has expressed no intention to regulate.* The creation of new areas of federal jurisdiction is the province of Congress and not the courts. As this Court noted in *United Steel Workers of America* v. *R. H. Bouligny, Inc.*, 382 U.S. 145, 150-51 (1965), "[P]leas" for the expansion of federal jurisdiction into "hitherto uncovered broad categories of litigants ought to be made to the Congress and not to the courts." See *Shamrock Oil and Gas Corp.* v. *Sheets*, 313 U.S. 100 (1941).

The Court's error in holding that all stock is a "security"** is highlighted by the contrary approaches recently adopted by the Third and Fifth Circuit Courts of Appeals. In *Lino* v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973), the Court flatly rejected a wooden reading of the definitional sections of the 1933 and 1934 Acts and held the "note" at issue in that case not a security, even though the literal language of the statutes appears to identify all notes as securities. In rejecting a literal construction, the Court stated:

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* The legislative history of the 1933 and 1934 Acts is silent as to coverage of transactions in personal residences. And legislation now pending in Congress to provide federal assistance for the development of cooperative housing, among other objects, nowhere acknowledges the applicability of the securities laws to cooperative memberships, but rather designates HUD as the agency to protect the "consumer interest." S. 3066, 93d Cong. 2d Sess., ch. I, §§401(d), 501(a)(1)(ii), 802(b) (1974).

** The Second Circuit's literal approach to the definition of "security" was recently reaffirmed in the case of *1050 Tenants Corp.* v. *Jakobson, supra*, in which the Court held a share of stock in a privately-owned cooperative to be a security under the federal securities laws. ("First, we ground our decision on what has been characterized as the 'literal approach' . . . .").

> "After considering the noted decisions and the arguments of both parties, it is our view that the legislation was not intended to cover the transaction which occurred here. All of the definitional sections involved in this case are introduced by the phrase 'unless the context otherwise requires.' The commercial context of this case requires a holding that the transaction did not involve a 'purchase' of securities." 487 F. 2d at 694.

And in *McClure* v. *First National Bank of Lubbock, Tex.*, 497 F.2d 490 (5th Cir. 1974), the Fifth Circuit refused to adopt the literal approach and held that a commercial promissory note made for business, not investment, purposes, was not a "security" within the meaning of the 1934 Act.*

III. The decision that residential property which is incapable of producing profit can nevertheless be a "security" undermines the long-established definition of "investment contract."

The Court of Appeals has held that a membership in a state subsidized and regulated nonprofit housing cooperative is an "investment contract" and thus a "security" subject to the federal securities laws. That unprecedented decision seriously undermines three decisions of this Court, as well as scores of Circuit Court decisions, which have firmly established profit as a necessary element of an "investment contract" under the securities laws.

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* The Fifth Circuit relied on *Lino* and on its prior decision in *Bellah* v. *First National Bank of Hereford, Tex.*, 495 F.2d 1109 (5th Cir. 1974). See also *SEC* v. *Continental Commodities Corp.*, No. 73-2429 (5th Cir. July 17, 1974); *Vincent* v. *Moench*, 473 F.2d 430 (10th Cir. 1973); *Sanders* v. *John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972), *cert. den.* 409 U.S. 1009 (1974), refusing to apply a literal test to the "note" exemption of the 1934 Act.

This Court enunciated the controlling definition of an investment contract nearly thirty years ago in *SEC* v. *W. J. Howey Co., supra*:

> ". . . [A]n investment contract [is] . . . a contract, transaction or scheme whereby a person invests his money in a common enterprise and *is led to expect profits* solely from the efforts of a promoter or a third party . . . ." 328 U.S. at 298-99 (emphasis supplied).

"Profit" is thus a key element in an investment contract (indeed, in every security). Moreover, as this Court held in *Howey*, the inducement of profits held out to prospective purchasers is a critical factor in the finding of an investment contract.* Three years earlier, this Court in *SEC* v. *C. M. Joiner Leasing Corp., supra*, focused on the same element—the promise of substantial profits:

> "The test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." 320 U.S. at 352-53.

Indeed, in *Joiner*, the Court suggested that if the profit inducements had not been included in the offer, the interests being sold might not have been investment contracts (320 U.S. at 348).**

The promise of monetary profit on one's investment, the inducement of substantial financial return, is thus a central and indispensable element of every investment contract.

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* It was noted that the purchasers "are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season . . . ." 328 U.S. at 296.

** This Court reaffirmed the vitality of the *Joiner* and *Howey* decisions in *Tcherepnin* v. *Knight*, 389 U.S. at 336-38.

The decisions which have relied on and articulated that principle are too numerous to cite.*

The District Court in this case, following these well-established principles, held that Co-op City's cooperative shares could not be investment contracts because they involved neither the promise nor the possibility of any profit:

> "[I]t is well to note at the outset of this inquiry that it is the fundamental nonprofit nature of this transaction which in this Court's view is the insurmountable barrier to plaintiffs' claims in this federal court." (B19)

* * *

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* See, *e.g.*, *SEC* v. *Haqenden-Rimar International, Inc.*, 496 F.2d 1192 (4th Cir. 1974), *aff'g* 362 F. Supp. 323 (E.D. Va. 1973) (sales of interests in scotch whiskey held to be investment contracts. Sales representations predicted investment return of 20 to 25% annually, doubling investment in four years. The District Court noted that even if defendants were merely selling an interest in whiskey, when that interest becomes the subject of speculation, it becomes a security); *Nor-Tex Agencies, Inc.* v. *Jones*, 482 F.2d 1093 (5th Cir. 1973), *cert. den.* —— U.S. —— (1974) (interest in real estate and mineral rights held to be an investment contract; Court held that buyer was induced to speculate in a fractional undivided oil and gas interest and led to expect profits); *SEC* v. *Koscot Interplanetary, Inc.*, No. 73-2339 (5th Cir. July 15, 1974) (Court held that pyramid promotion enterprise involved sale of investment contracts—"Koscot thrives by enticing prospective investors to participate in its enterprise, holding out as a lure the expectation of galactic profits"); *Glen-Arden Commodities Inc.* v. *Costantino*, 493 F.2d 1027 (2d Cir. 1974) (sales of warehouse receipts and evidences of ownership in casks of Scotch whiskey are investment contracts. The Court noted that the "economic inducements" were in the nature of inducements to invest: the lure was not securing scotch but doubling one's money); *SEC* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), *cert. den.* 414 U.S. 821 (1973) (Turner was not selling lectures to improve sales ability but a "sure route to easy riches," a "get-rich-quick" scheme—an investment contract—in this pyramid promotion scheme); *Continental Marketing Corp.* v. *SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. den.* 391 U.S. 905 (1968) (sale of beavers is investment contract: promise of "geometric profits").

> ". . . [N]one of the documents involved in this transaction . . . ever, once use material, tangible profits as an inducement . . . [and] it is clear that the Co-op City residents did not purchase the shares with any expectation of profits, as the word is generally used in commerce. These shares are incapable—by law and by-law—of producing any monetary or fungible return." (B21-22)

In reversing, the Court of Appeals did not find that these cooperative shares could generate profit—as that word is ordinarily used in commerce. Neither did it find there was any inducement, promise or expectation of profit. Nevertheless, it held the cooperative shares to be "investment contracts" and thus "securities," because of savings in personal living expenses (through lower rent and tax deductions) which might be realized by members of the cooperative. That expansion of the concept of "profit," to include the benefits of a public welfare program is, we suggest, an index to the logic of the entire decision. The saving on living expenses enjoyed by residents of Co-op City comes principally from the millions of dollars of government subsidies devoted to the project. The purpose of these subsidies was to meet the urgent housing needs of the citizens of the state,* and not to permit cooperative members to earn a "profit." It is simply astounding to conclude—as did the Court of Appeals—that the benefits of these subsidies are the equivalent of "profit" so as to make Co-op City's cooperative shares the equivalent of speculative interests in orange groves and scotch whiskey.

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* Housing Law §§11, 11-a.

IV. The Court of Appeals decision conflicts with guidelines issued by the Securities and Exchange Commission.

In holding Co-op City's cooperative memberships to be "investment contracts" because they might generate "profit" in the form of savings in personal living expenses, the Court of Appeals ran roughshod over rules announced just last year by the Securities and Exchange Commission. Those rules establish guidelines to assist builders of cooperatives and condominiums in determining when their units are "investment contracts" within the meaning of the *Howey* decision and thus "securities," which must be registered, under the federal securities laws.

In Securities Act Release No. 33-5347 (January 4, 1973), the Securities and Exchange Commission announced that purchases and sales of units in conventional residential developments are not transactions in securities.* Rather, residential units are securities only where there is an ex-

* Although Release No. 33-5347 focuses mainly on condominiums, it applies equally to cooperatives. The Release, by its terms, applies to condominiums and "similar types of real estate developments" and refers specifically to cooperative units in several places. Moreover, the Release was issued in response to the Report of the Securities and Exchange Real Estate Advisory Committee established by Chairman William Casey in May of 1972. The Report notes that condominiums and cooperatives should be subject to the same rules:

> "Whether or not the indirect form of property ownership (cooperative) or the direct form of property ownership (condominium) is chosen is most often dictated by such factors as tax impact, zoning, government, insurance or subsidy programs, local acceptance, and the like. The focus from the standpoint of the securities laws should be to separate housing opportunities from investment opportunities properly subject to securities law protection and not on forms of ownership."
>
> Report of the Real Estate Advisory Committee to the Securities and Exchange Commission (October 12, 1972), page 89.

pectation of "profit" as that term is generally used in commerce. Thus the Release states:

> "The existence of various kinds of collateral arrangements may cause an offering of condominium units to involve an offering of investment contracts or interests in a profit sharing agreement. *The presence of such arrangements indicates that the offeror is offering an opportunity through which the purchaser may earn a return on his investment through the managerial efforts of the promoters* or a third party in their operation of the enterprise." (Emphasis supplied.)* (D8).

In promulgating these views, the Securities and Exchange Commission expressly rejected the notion—adopted by the Court of Appeals in this case—that the presence of commercial income from incidental commercial facilities creates a security, stating:

> "In situations where commercial facilities are a part of the common elements of a residential project,

* The Release identifies three situations in which condominium and like interests are securities and therefore must be registered under the 1933 Act:

> "In summary, the offering of condominium units in conjunction with any one of the following will cause the offering to be viewed as an offering of securities in the form of investment contracts:
>
> "'1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units. [*sic*]
>
> "'2. The offering of participation in a rental pool arrangement; and
>
> "'3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.'" (D9-10)

> no registration would be required under the investment contract theory where (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit." (Emphasis supplied.) (D11)

Thus, in the case of residential developments, the SEC does not consider the alleged "profit" from personal income tax deductions, incidental commercial facilities, "below market" or "optimum level" housing costs or even possible gain on resale as "profit" that triggers the *Howey* investment contract test. Instead, consistent with the principles of *Howey*, and indeed of all other securities cases, the SEC's rules on housing units apply only where the purchasers are induced to buy their interests by promises of substantial investment profit.*

Significantly, the Court below did not even mention the SEC guidelines in announcing its novel theory of "profit." That decision now casts doubt on the continued viability of the SEC release and defeats in large part its very purpose, which is to provide guidance on the extent to which existing securities laws and regulations may be applicable to cooperatives and condominiums. The thousands of builders and developers who have relied and are relying on the SEC guidelines can no longer so do with any confidence.

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* Such cases typically involve resort area facilities which are held out to have high potential for rental income and which often require a pooling and proration of rental receipts from all units.

Conclusion

For the foregoing reasons, this petition should be granted and a writ of certiorari should be issued to review the decision below.

Respectfully submitted,

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APPENDICES

Appendix A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 747—September Term, 1973.

(Argued April 4, 1974 Decided June 12, 1974.)

Docket No. 73-2613

MILTON FORMAN and ELLEN FORMAN, *et al.*,
Appellants,

v.

COMMUNITY SERVICES, INC., UNITED HOUSING FOUNDATION, HAROLD OSTROFF, ROBERT SZOLD, MILTON ALTMAN, GEORGE SCHECHTER, ANTHONY MARINO, PAUL KRAMER, IRVING ALTER, JULIUS GOLDBERG, STATE OF NEW YORK and NEW YORK STATE HOUSING FINANCE AGENCY,
Appellees.

Before:

HAYS and OAKES, *Circuit Judges,*
and CHRISTENSEN, *District Judge.**

Appeal from an order of the United States District Court for the Southern District of New York, Lawrence W. Pierce, *Judge,* dismissing for lack of federal jurisdiction a complaint alleging violations of 15 U.S.C. §§77q(a), 77v(a), 78t, 78aa, 42 U.S.C. §1983, and 17 C.F.R. §240.10b-5.

Reversed and remanded.

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* Senior United States District Judge for the District of Utah, sitting by designation.

LOUIS NIZER, New York, N.Y. (Phillips, Nizer, Benjamin, Krim & Ballon; George Berger, Jay F. Gordon, Richard S. Brooks, Janet P. Kane, New York, N.Y., of counsel), *for Appellants.*

SIMON H. RIFKIND, New York, N.Y. (Paul Weiss, Rifkind, Wharton & Garrison; Alan G. Blumberg, New York, N.Y.; Martin London and George P. Felleman, of counsel), *for Appellees.*

DANIEL M. COHEN, Assistant Attorney General (Louis J. Lefkowitz, Attorney General of the State of New York; Samuel A. Hirshowitz, First Assistant Attorney General, of counsel), *for Appellees State of New York and New York State Housing Finance Agency.*

OAKES, *Circuit Judge*:

This appeal by resident tenants of Co-op City presents the question whether a share of stock in a cooperative apartment nonprofit company chartered and subsidized under the State of New York's Mitchell-Lama Act[1] is a "security" within the meaning of the federal securities laws. All the appellees urge that because there is no promise, expectation or possibility of profit in connection with a member's resale of a cooperative share and because the cooperative housing company is created pursuant to an emergency state program for low cost housing, state financed and supervised, and sponsored by a nonprofit foundation, that cooperative shares in it are not securities. The appellee New York State Housing Finance Agency ("the agency") also claims not to be a "person" within

1. New York Private Housing Finance Law §§10-37.

the meaning of the Civil Rights Act of 1871, 42 U.S.C. §1983, and its jurisdictional counterpart, 28 U.S.C. §1343 (3), and the appellee State of New York claims not to be a proper defendant under 42 U.S.C. §1983, as well as immune under the eleventh amendment of the United States Constitution. The court below, finding that the co-operative shares involved were not "securit[ies]," dismissed the counts of the amended complaint alleging violations of the federal securities laws as to all defendants and, since the federal securities allegations represented the only "well pleaded" underlying basis for jurisdiction under the Civil Rights Act, dismissed the complaint as to the state agency. The remaining counts were dismissed as against the named defendants, since they set forth pendent claims asserted pursuant to state law. *United Mine Workers* v. *Gibbs,* 383 U.S. 715, 726 (1966). The complaint was therefore accordingly dismissed in its entirety for lack of subject matter jurisdiction. 366 F. Supp. 1117 (S.D. N.Y. 1973). Expressing no opinion whatsoever on the merits, but finding jurisdiction nevertheless, we reverse and remand.

Appellants are 57 residents owning some 30 apartment units in Co-op City, a huge low-middle income cooperative housing project located in the borough of the Bronx, New York City. Co-op City is apparently the largest cooperative housing development in the United States, presently housing some 45,000 people, with more than 30 high-rise buildings and 230 town houses and a total of 15,400 apartment units ranging from three to seven rooms, on a 200-acre site. Appellants allege on behalf of themselves and all other residents violations by the defendants of the

antifraud provisions of the Securities Act of 1933, 15 U.S.C. §77q(a), and the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5. The complaint alleges in respect to the defendant New York State Housing Finance Agency that plaintiffs' civil rights have been violated by virtue of the securities law violations alleged directly against the other defendants.

The corporate defendants, appellees here, include United Housing Foundation (UHF) which initiated and sponsored the project. UHF was formed in 1951 under New York's nonprofit corporation statute, New York Not-for-Profit Corporation Law, with the purpose of fostering the growth of nonprofit cooperative housing for low and low-middle income families and, in addition to Co-op City, it has participated in the sponsorship of several other New York cooperative housing projects; UHF's membership includes housing cooperatives, civic groups and labor unions. Community Service, Inc. (CSI), is the general contractor and sales agent for the project. CSI was organized under the New York Business Corporations Law, for profit, even though it is a wholly owned subsidiary of UHF. The third corporate defendant is Riverbay Corporation (Riverbay), which is the cooperative housing corporation in which plaintiffs purchased shares and which owns and operates the project. Riverbay was organized by UHF as a "mutual company" under New York's Mitchell-Lama Act, note 1, *supra*;[2] it is named as a defendant here principally, if not

2. The act essentially provides for the creation of "limited profit housing companies," §13, which, subject to state or local supervision, may borrow up to 95 per cent of the project cost at low interest from

[*footnote continued on next page*]

only, in respect to the derivative causes of action alleged on its behalf under New York state law. The individual defendants are officers or directors or both of some or all of the corporate defendants. Pursuant to the Mitchell-Lama Act, the defendant agency provided the bulk of the financing for the project through long-term low-interest mortgage loans, and the defendant New York State Division of Housing and Community Renewal (the "Division of Housing") through its commissioner is responsible for the supervision of the development, construction, promotion and operation of the project.

Basically under the Mitchell-Lama Act, cooperatives which are subsidized and supervised are owned by a mutual company formed under the Act, the stock of which is held by the actual tenants, as here. Section 12(2-b). No one may live in the project whose probable aggregate income exceeds six times the rental fees, §31(2)(a), (b), and there is a preference to the aged, the handicapped and veterans, §§11, 31(7)(a), (b). Plaintiffs here secured their right to occupancy by completing a subscription agreement and apartment application form wherein they agreed to subscribe to 18 shares of Riverbay common stock at $25 par value per share for each room in the apartment they selected. Under the bylaws of Riverbay, each stockolder is entitled to only one vote on any and all matters regardless of the number of shares of capital stock or any other equity obligations of the housing company which the stockholder owns. Also, the stock may not be

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the state or a municipality to construct and operate the project, rent apartments therein, etc. Sections 22, 27-31. Tax exemptions are provided, §33, as is the right of condemnation on behalf of a municipality for the cooperative company, §29.

owned separate and apart from actual occupancy in Co-op City, nor may it be pledged or otherwise encumbered. The shares descend intact (together with the right to occupancy) only to a surviving spouse, and a tenant who wishes to move out or is forced out, whether by way of violation of the lease or by virtue of his income, must divest himself of the stock by offering it for repurchase, in which case he will be compensated with exactly the amount he paid for the stock. In the event Riverbay does not exercise its right to repurchase (for which it had established a reserve fund of approximately $917,000 as of December 31, 1972), the stockholder is free to sell his shares elsewhere, although under §31-a of the Mitchell-Lama Act he may not sell them for more than the original purchase price plus a pro rata fraction of the mortgage amortization paid during his tenure at Co-op City.

The obligations of the Co-op City resident flow from his lease, not from his stock. In addition, to what the trial court has termed the usual landlord-tenant covenants with respect to services and care of the premises, the resident is required to pay annual carrying charges pro rated in advance monthly payments, the pro rata portion being based not on the number of shares owned but on the size, type and location of his apartment. This monthly payment is, as in the case of other cooperatives, in reality rent, that is to say, it represents a proportionate allocation of the expenses of Riverbay in connection with the ownership, maintenance, operations, taxes, mortgage indebtedness, repairs, improvements, wages for employees, etc.

Appendix A

The gravamen of the appellants' amended complaint relates to the carrying charges for Co-op City apartments, and particularly the initial "Information Bulletin" circulated by CSI as sales agent for Riverbay through the mail, originally setting forth an estimated average monthly carrying charge of $23.02 per room. This meant that a prospect for a four-room apartment could expect to pay $1,800 for stock in Riverbay and a monthly rent thereafter of $92.08. The cost of the project, however, increased while it was being built, and in 1968 the current "Information Bulletin" was revised upward to $25 per room per month, then in 1970-72 to $29.39, then in 1973-74, $35.27. Because it is now estimated that the charge will be $39.68 effective July 1, 1974, what originally was a $92.08 monthly rental bargain for a four-room apartment will now be $148.72 per month. For those who have fixed incomes or whose wages have not gone up with inflation, the change in carrying charges is most serious.[3] The complaint charges in substance that there were misrepresentations and material omissions in the "Information Bulletins." It is said, for example, that there was stated a lump sum price of $258,678,000 for the construction of the project to be financed with a $250,000,000 mortgage from the agency, and the Bulletin did go on to state that "the risk of completing the construction within the lump sum price is on the contractor." However, it is alleged, the agency and other defendants agreed to a final construction bill of $340,500,000, which was financed through

3. At the same time, because the maximum income eligibility is related to carrying charges, there has been a proportionate increase therein, so that, as the district court pointed out, for tenants who are employed it is possible that little or no real hardship has occurred.

a $125,000,000 increase in the mortgage loan, thereby substantially increasing the carrying charges.[4] Some other allegations apparently are that the "Information Bulletins" failed to disclose that the State Housing Commissioner had waived the liquidity requirement for contractors imposed by the Guide for Development of Limited Profit Housing, Preliminary Submissions, State of New York Division of Housing and Community Renewal p. 35, and further failed to disclose that the contractor was a wholly owned subsidiary of UHF.

As stated above, the district court determined that the shares in Riverbay were not securities within the meaning of the federal securities laws, and therefore the court was without jurisdiction over the claims. This holding we reverse for reasons which follow, finding the Riverbay shares to be securities within the federal law and thus conferring federal jurisdiction over appellants' claims. As to the substance of those claims, whether they state claims for which relief can be granted or whether any damages are cognizable, as we have said, we intimate no conclusion.

The definition of "security" in the Securities Exchange Act of 1934, §3a(10), 15 U.S.C. §78c(10), is set out in full in the margin,[5] but for our purposes may be read as fol-

4. Of course, on the merits the appellees would point out that the "Information Bulletins" state that the lump sum price is subject to addition or deduction for change orders during the progress of construction and that they also warn that it is possible that increases in costs may increase the average monthly estimate.

5. 15 U.S.C. §78c(10):

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral

[*footnote continued on next page*]

lows: "The term 'security' means any . . . stock . . . investment contract . . . or in general, any instrument commonly known as a 'security'. . . ." The definition in the Securities Act of 1933, 15 U.S.C. §77b(1), is "virtually identical" and interchangeable with that in the 1934 Act, *Tcherepnin* v. *Knight*, 389 U.S. 332, 335-36 (1967); *Glen-Arden Commodities, Inc.* v. *Costantino*, Nos. 74-1039, -1069, -1236 (2d Cir. Mar. 14, 1974), slip op. 2175, 2187 n.6.

It should be mentioned that shares have not yet been issued to the appellants. For all purposes, however, we may treat the case as if the shares had been issued. Appellants have all signed the extensive subscription agreement under which they subscribe to class B capital stock of Riverbay Corporation at par value (the number of shares depending on the number of rooms in the apartment), and they all agreed to pay the full subscription price on the signing of the application. We agree with the court below (and the appellees do not seriously contend otherwise) that despite a contrary statement in the subscription agreement[6]

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royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

6. The application states that the stock is not to be issued or delivered until the project has been completed and a certificate of acceptability to the housing company has been issued by the commissioner. It also states that "Until so issued and delivered, the Subscriber shall not be deemed to be a stockholder nor the holder of any other equity obligation of the Housing Company." Paragraph (5).

the tenants of Co-op City have purchased the right to own shares, and that is enough under the federal statutes to bring them within their coverage. 15 U.S.C. §78c(a)(13).[7] In total the shareholders of Riverbay have paid $32,803,200 for their stock.

Some incidents of ownership of Riverbay common stock are identical to those of other cooperative real estate corporations' stock. The owner of the certificate has the right to vote in the affairs of the corporation.[8] He has the right to take income tax deductions for a portion of his monthly carrying charges. He has the right to enter into an occupancy agreement and his shares upon his death pass to his spouse together with the right to occupy. Rental income from Riverbay's leases of commercial and office space is available to pay its general expenses, thereby reducing its need for carrying charge income from the appellants. Other aspects of Riverbay stock are common but not universal. For instance, the stock may not be pledged or otherwise encumbered or owned by someone who does not occupy one of the cooperative apartments. *Cf. Penthouse Properties, Inc.* v. *1158 Fifth Avenue, Inc.*, 256 App. Div. 685, 11 N.Y.S.2d 417 (1st Dep't 1939). If a stockholder wishes to sell or must sell, Riverbay has the right of first

7. 15 U.S.C. §78c(a)(13) provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

8. While the owners do not, as is usually the case, have a separate vote for each share held, instead having one vote per apartment, this would have little, if any, functional difference where here one has one vote among some 45,000 and where otherwise the maximum one could have would be 126 votes (18 shares times seven rooms) of over one million. In either case any individual's vote or votes would not be terribly significant.

refusal to purchase. More unusual is the provision that the right of repurchase by Riverbay is at the *original* purchase price. Even this, however, is not a unique provision. *See, e.g., Allen* v. *Biltmore Tissue Corp.*, 2 N.Y.S.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957). Thus it can be seen that basically the stock here is similar to that of other cooperative real estate corporations. Such stock has recently been held to be a security under the Securities Acts. *1050 Tenants Corp.* v. *Jakobson,* 365 F. Supp. 1171 (S.D. N.Y. 1973), *appeal pending.*

One basis for such a finding is the so-called literal approach. *See* Jennings & Marsh, Securities Regulation 299-300 (3d ed. 1973); Note, *Cooperative Housing Corporations and the Federal Securities Laws,* 71 Colum. L. Rev. 118 (1971); Sobieski, *Securities Regulation in California: Recent Developments,* 11 U.C.L.A. L. Rev. 1, 7-8 (1963); Wenig & Schulz, *Government Regulation of Condominiums in California,* 14 Hastings L.J. 222, 233 (1963). According to this approach the fact that "stock" certificates are used in a "stock" corporation is sufficient in itself to bring transactions in the "stock" within the literal definition of the Acts. As Jennings & Marsh state at 299-300, "When a stock corporation is used, the securities acts literally apply, even though the profit motive is not dominant." Professor Loss has put it, "When the ownership of an individual apartment is evidence by stock in the cooperative, as it usually is, the federal and state securities statutes would seem literally to apply." 1 L. Loss, Securities Regulation 492-93 (2d ed. 1961) (footnotes omitted). Judge Mansfield as a district judge supported the literal application of specific definitions of securities so as to *include* instruments within

the coverage of the acts. *Movielab, Inc.* v. *Berkey Photo, Inc.*, 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971). The Supreme Court said in *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), *reaffirmed in Tcherepnin* v. *Knight*, 389 U.S. at 339,

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning. . . . *Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.* However, the reach of the Act does not stop with the obvious and commonplace. . . .

(Emphasis added.) This language gives support to the proposition that if a given instrument is a share of stock "on its face" it is literally within the ambit of the statute. Expansive or interpretive readings given to other definitions within the Act, principally "investment contracts," generally have been to bring debatable transactions *within* the statute's coverage. It may be argued, moreover, that there is some underlying justification for such a formal approach. That is, where one utilizes the outward and traditional manifestations of a "stock" organization, the buyer may be led to believe that what he is buying is "stock" as normally considered and which would be protected by the federal or state securities laws. Indeed, the buyer of the purported "stock" may rely to some extent on the notion that he will at least be protected by those laws. It would be anomalous, the argument runs, were

one who was defrauded as to the nature of the instrument, "stock" on its face, to be deprived of antifraud provisions directed at "stock" transactions.

Appellees, nevertheless, argue that we must examine the context in which the instrument in question arose and whether that context warrants a literal application of the terms of this statute, for the definitional section, §3(a) of the 1934 Act, 15 U.S.C. §78c(a), commences:

> (a) When used in this chapter, *unless the context otherwise requires*—
>
> . . . .
>
> (10) [definition of security]

(Emphasis added.) There is no doubt that the 1933 and 1934 Acts arose in the first instance in connection with the regulation of conduct in commercial marketplaces primarily to require disclosure of financial information for the protection of investors, curbing excessive speculation, market manipulation and the like. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 2 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 3-5 (1934). And as *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. at 351, said, "the term 'security' was defined to include by name or description many documents in which there is common trading for speculation or investment." Thus while form has been disregarded for substance customarily in *extending* coverage of the Act, *Tcherepnin* v. *Knight*, 389 U.S. at 336, there is still substantial authority for the proposition that substance should govern rather than form even to restrict coverage of the Acts. *See* 1 Loss, *supra*, at 493 ("just as some things which look like real estate are securities, some things

which look like securities are real estate"). *Lino* v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973) (promissory notes given in part payment of purchase price by franchise purchaser held not to be security). *See also SEC* v. *Fifth Avenue Coach Lines, Inc.*, 289 F. Supp 3 (S.D.N.Y. 1968) (note given for personal loan), *aff'd without consideration of the point*, 435 F.2d 510 (2d Cir. 1970).

However, appellees would be no better off were we to agree with them that we must look through form to substance even where the result is to limit coverage of the Act.[9] Interestingly, although the SEC has not said whether it is treating cooperative shares formally as stock or substantially as "investment contracts," by Rule 235 of the General Rules and Regulations under the Securities Act of 1933, 17 C.F.R. §230.235, the SEC has exempted from registration the stock of certain cooperative housing corporations and thereby implicitly recognized that other cooperative housing securities might be subject to other provisions of the securities laws. *Cf. Tcherepnin* v. *Knight*, 389 U.S. at 341-42. *See also SEC* v. *Associated Gas & Electric Co.*, 99 F.2d 795, 798 (2d Cir. 1938).

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9. We note that the Supreme Court continues to remind us that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). We also note that cooperative stock is subject to the Blue Sky laws of many states, including those of New York, as acknowledged by the court below, 366 F. Supp. at 1121 n.10. *See* New York General Business Law §352-e.

Appendix A

To look to the substance of the term "stock" is in essence to determine if an "investment contract" of some sort exists. The basic test to ascertain the presence of an "investment contract" was formulated by the Supreme Court in *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946):

> In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .

Appellees argue, as the trial court found, that there is no promise, expectation or possibility of profit[10] in connection with a member's resale of Riverbay's cooperative shares, and that this "nonprofit nature" together with the "noncommercial nature" of the development and the "rigid statutory controls" over the enterprise compel the conclusion that the shares are not "investment contracts" and hence securities under the federal laws. While these arguments are not without legal support, we are not persuaded by them. Before considering the question of profit, there is no doubt that in the words of *Howey* there was here a "transaction whereby a person invests his money in a common enterprise" and that if there is any expectation of profits at all that these would come "solely from the efforts of the promoter or a third party."

The harder question is, of course, whether there is any expectation of profit by appellants. Initially it must be

10. Appellees would use that term mechanically or literally and not in the sense of "economic inducement" that the Court referred to in *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. at 352-53. *See also SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967).

conceded that there is no possible profit on a resale of the stock. If Riverbay does not buy the stock back at its original price, the shareholder can only sell it for the original price plus a fraction of his pro rata amortization of the mortgage. Private Housing Finance Law §31-a. Profit, however, need not be realized only in capital appreciation; equally important is the possibility of income from the investment. Here the shareholders have an expectation of "income" in at least three ways. First, and most directly, the tenant shareholders are able to share in the income from the leasing of retail establishments, office space, parking, and other commercial enterprises on the premises. The retail stores allegedly pay some $1,106,000 in rent to Riverbay. Income from renting office space and from coin-operated washing machines is stated to be $667,000 annually. Finally, some $2.5 million per year in parking fees is apparently collected from both tenants and others. In short, the shareholders may share—through the corporation—in substantial income Admittedly, this income is not likely to come in the form of a dividend check (although according to the law dividends may be paid after all costs and expenses have been paid, *see* Private Housing Finance Law §28) but rather in the form of reduced carrying charges to shareholder/tenants. The form that this income takes, however, is not determinative; in either case the shareholders are receiving a direct monetary benefit and, as such, "profit" within the *Howey* concept. *See 1050 Tenants Corp.* v. *Jakobson,* 365 F. Supp. at 1176. *See also Davenport* v. *United States,* 260 F.2d 591 (9th Cir. 1958), *cert. denied,* 359 U.S. 909 (1959) (purchasers of cooperative memberships promised job security in plant to be con-

structed); *SEC* v. *American Foundation for Advanced Education,* 222 F. Supp. 828 (W.D. La. 1963); *Silver Hills Country Club* v. *Sobieski,* 55 Cal. 2d 811, 361 P.2d 906 (1961) (Traynor, J.); 1 L. Loss, *supra,* at 493-94; Zammit, *Securities Law Aspects of Cooperative Housing,* 169 N.Y.L.J. No. 5, at 1, col. 3 (Jan. 8, 1973); Note, *supra,* 71 Colum. L. Rev. at 129-31.

Another way of realizing income through the ownership of shares in Riverbay is the ability to partake of certain tax benefits—notably a deduction for a pro rata share of the mortgage interest payments. Investment schemes whose purpose is to provide tax losses and thereby generate deductions are usually reserved for the well-heeled, but here the opportunity to make tax savings, even for those in a low bracket, is a substantial inducement to buy shares, where the alternative is the payment of rent with no tax benefits. *See 1050 Tenants Corp.* v. *Jakobson,* 365 F. Supp. at 1176.

A third way in which it might be viewed that profits may be realized is in the saving of an expense which would otherwise necessarily be incurred. In other words, where the going rate for rents in a given area is one amount, an investment opportunity offering housing at an amount substantially below that going rate is an offer of a "profit," for housing is a necessity and any saving on that necessity is money in one's pocket. While the state cases are, of course, not binding upon us, we incline to agree with *State ex rel. Troy* v. *Lumbermen's Clinic,* 186 Wash. 384, 394-95, 58 P.2d 812, 816 (1936):

> A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited.

> If respondent renders to its incorporators or members, or to businesses in which they are interested and in whose profits they share, a service at a cost lower than that which would otherwise be paid for such service, the respondent's operations result in a profit to its members.

See also Pine Grove Manor, Inc. v. *Director,* 68 N.J. Super. 135, 171 A.2d 676 (Super. Ct. App. Div. 1961); *Commonwealth* v. *2101 Cooperative, Inc. (No. 1),* 27 Pa. D.&C.2d 405 (C.P. 1961), *aff'd per curiam,* 408 Pa. 24, 183 A.2d 325 (1962); *State ex rel. Russell* v. *Sweeney,* 153 Ohio St. 66, 41 Ohio Op. 143, 91 N.E.2d 13 (1950). Viewing the savings, which were promised here by appellees, over rents for comparable accommodations as "profits" as well, we find a contract for an investment, which carried with it a risk of loss of that investment, to be an invesment contract under the Securities Acts.

The fact that the shares are issued and sold by a nonprofit corporation is in and of itself immaterial; certainly if the corporation went bankrupt, the shareholders would have sustained a loss in the amount of their investment, and there is nothing to say that a nonprofit corporation necessarily must not go bankrupt. Nor is there anything in the nonprofit nature of a corporation which provides assurances that it will not deceive and defraud buyers or owners of shares.

The fact, too, that the cooperative was created and remains under considerable general supervision of the State of New York through its Housing Agency and Commissioner of the Division of Housing surely does not remove the stock from the federal Securities Acts' ambit. In the first place, many of their regulatory duties are aimed at

preserving the quality of the assets supporting the mortgage loan. Their principal purpose thus is not necessarily to protect the shareholders. Indeed, there are any number of industries such as public utilities that are at least as closely regulated by the State as are the sponsor, contractor and cooperative company here and whose stock is clearly subject to federal regulation. Nor does the fact that there are eleemosynary elements underlying the statute, perhaps indeed underlying the services rendered by the nonprofit sponsor, UHF, take the case from without the protection of the securities laws. Indeed, the for-profit subsidiary of UHF, CSI, the contractor here, could very well stand to benefit substantially by the price paid to it for its contracting services, the very point at issue under the appellants' pleadings.[11] The fact that there may be no profit motive on the part of the promoter, UHF, does not by any means affect the profit motives on the part of the subscribers above referred to, nor would it necessarily affect the profit motive on the part of the contractor, the directors and officers of whom might conceivably—were they evil men—be receiving considerable compensation. Nor would the lack of a profit motive eliminate the incentive for fraudulent or deceptive practices in the sale of cooperative stock. Whether it were to recoup advances already made or to retain a particular reputation even a nonprofit entity may encounter pressures which might have the tendency to change an otherwise objective and fair sales pitch to something likely to entice and mislead.

11. This, of course, is a question on the merits, in the event that a claim is actually stated for which relief can be granted, as to which we express no opinion.

We hold, then, that a share in Riverbay is both "stock" and an "investment contract" under the Securities Acts. We pass to the special defenses of the State Housing Finance Agency and of the State of New York.

The State Housing Finance Agency argues that it may not be charged with violation of §1983. While municipal corporations, that is, municipalities, are not deemed "persons" under the Civil Rights Act, *see Monroe* v. *Pape*, 365 U.S. 167, 187-90 (1960), "agencies" have always been so deemed. *See, e.g., Escalera* v. *New York City Housing Authority*, 425 F.2d 853 (2d Cir. 1970), *cert. denied*, 400 U.S. 853 (1971); *Holmes* v. *New York City Housing Authority*, 398 F.2d 262 (2d Cir. 1968). The agency here, moreover, is not protected by sovereign immunity. First, Private Housing Finance Law §32(5)[12] expressly waives sovereign immunity for the agency. Even were such a waiver absent, the agency is not an "alter ego" of the state, *see Whitten* v. *State University Construction Fund*, —— F.2d —— (1st Cir. 1974) (Moore, J.), and hence not a recipient of sovereign immunity. The State Housing Finance Agency has the express authority to sue and be sued; it acts only as a credit or financing entity; it apparently has no power to take property in its own name or in the name of the State. In *Whitten* the court found "ultimate State liability" to be the most crucial determination.

12. Section 32(5):

> With regard to duties and liabilities arising out of this article the state, the commissioner or the supervising agency may be sued *in the same manner as a private person.* No costs shall be awarded against the commissioner, the state, or the supervising agency, as the case may be, in any such litigation.
>
> (Emphasis added.)

Here the State is expressly *not* liable for the debts of the agency. Private Housing Finance Law §46(8). Thus, upon these considerations it would appear that the agency here is sufficiently independent of the State as not to enjoy sovereign immunity. *Compare Matherson* v. *Long Island State Park Commission*, 442 F.2d 566 (2d Cir. 1971) (Jones Beach Parkway Authority not alter ego); *Zeidner* v. *Wulforst*, 197 F. Supp. 23, 25 (E.D.N.Y. 1961) (New York Thruway Authority not alter ego); *In re Dormitory Authority*, 18 N.Y.2d 114, 271 N.Y.S.2d 983, 218 N.E.2d 693 (1966) (Dormitory Authority of State of New York has no sovereign immunity); *Story House Corp.* v. *Job Development Authority*, 37 App. Div. 2d 345, 325 N.Y.S.2d 659 (3d Dep't 1971), *aff'd mem.*, 31 N.Y.2d 942, 340 N.Y.S.2d 929, 293 N.E.2d 97 (1972) (State of New York Job Development Authority has no sovereign immunity), *with Whitten* v. *State University Construction Fund, supra* (State University Construction Fund has sovereign immunity; *Charles Simkin & Sons, Inc.* v. *State University Construction Fund*, 352 F. Supp. 177 (S.D.N.Y.), *aff'd mem.*, 486 F.2d 1393 (2d Cir. 1973) (State University Construction Fund has sovereign immunity); *State University of New York* v. *Syracuse University*, 206 Misc. 1003, 137 N.Y.2d 916 (Sup. Ct.), *aff'd*, 285 App. Div. 59, 136 N.Y.S.2d 539 (3d Dep't 1954) (State University has sovereign immunity).

The State itself argues that the court below lacks jurisdiction over it. Again, however, the State has expressly waived sovereign immunity in Private Housing Finance Law §32(5), note 12 *supra*. Secondly, the State has waived its sovereign immunity with respect to federal securities laws violations by voluntarily entering a field

under federal regulation. *See Parden* v. *Terminal Railway of Alabama Docks Department*, 377 U.S. 184 (1964). Thus when the State enacted the Mitchell-Lama Act in 1955 and codified it in 1961, it did so with the knowledge that transactions involving subscriptions for stock solicited through the mails were already within the ambit of federal anti-fraud regulations and statutes. To paraphrase the court's opinion in *Parden*, 377 U.S. at 192, by enacting the federal securities laws in the exercise of the Commerce Clause—a power given to the federal government by the states in adopting and ratifying the constitution—the Congress conditioned the right to be involved in the sale and distribution of securities upon amenability to suit in federal court as provided by those regulatory laws.[13] Were there any doubt that the securities laws were intended to reach states or their agencies, the legislative history dispels it. *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 11.

Again, in reversing the district court we make no suggestion regarding the viability of appellants' claims, except to find that the cooperative shares involved are securities so as to confer jurisdiction on the federal court.

Judgment reversed and remanded.

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13. *Employees* v. *Missouri Public Health Dept.*, 411 U.S. 279 (1973), is distinguishable. There, unlike this case and *Parden*, the state's activity came first, the federal regulation second. In this posture, the Court held, the state could not be found to have waived its immunity; rather Congress would be required explicitly to override it. Here and in *Parden*, however, the regulatory system was in effect before the state entered the field. That entry into the regulated field thus constituted a waiver of the state's immunity.

Appendix B

Opinion of the District Court

MILTON and ELLEN FORMAN *et al.*,
Plaintiffs,

v.

COMMUNITY SERVICES, INC., *et al.*,
Defendants.

No. 72 Civ. 3980.
United States District Court,
S. D. New York.
Sept. 6, 1973.

George Berger, Phillips, Nizer, Benjamin, Krim & Ballon, New York City, for plaintiffs.

Martin London, Paul Weiss, Rifkind, Wharton & Garrison, New York City, for defendants Community Services, Inc., United Housing Foundation, Harold Ostroff, Robert Szold, Milton Altman, George Schechter, Anthony Marino, Irving Alter, Julius Goldberg, and Paul Kramer.

Alan G. Blumberg, Szold, Brandwen, Meyers & Altman, New York City, for defendants Szold, Altman, Alter.

David Peck, Sullivan & Cromwell, New York City, for Riverbay Corp.

Louis J. Lefkowitz, Atty. Gen. of the State of New York by Daniel M. Cohen, Asst. Atty. Gen., New York City for defendants State of New York and New York State Housing Finance Agency.

Appendix B

PIERCE, District Judge.

This action has been commenced by 57 residents of Co-op City,[1] a low-middle income cooperative housing project located in the Borough of the Bronx, New York City. They sue on behalf of themselves and all other residents of Co-op City, alleging, among other things, violations of the anti-fraud provisions of the Securities Exchange Act of 1934,[2] and of the Securities Act of 1933,[3] in connection with the sale to plaintiffs of shares of the common stock of the cooperative housing corporation.

The amended complaint also asserts violations of the plaintiffs' civil rights by one of the government defendants,[4] premised upon the protections afforded by the federal securities laws; and it further sets forth several claims, pendent to the federal claims, based on New York State law, including an asserted derivative cause of action on behalf of the cooperative corporation.

The corporate defendants constitute the amalgam which conceived, built, promoted and, at this time, controls the management of Co-op City. United Housing Foundation (UHF) initiated and sponsored the project.[5] UHF was

1. Many are husbands and wives who own jointly their interest in a single apartment unit. Thus, altogether, there are occupants of 30 apartments named as plaintiffs.

2. 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder (17 C.F.R. §240.10b-5).

3. 15 U.S.C. §77q(a).

4. 42 U.S.C. §§1983, 1988.

5. UHF was formed in 1951 with the primary purpose of fostering the growth of nonprofit cooperative housing for low and low-middle income families. In addition to Co-op City, it has sponsored or participated in the sponsorship of more than eight other cooperative housing projects located in various boroughs of New York City.

organized under New York's nonprofit corporation statute[6] and is comprised of housing cooperatives, civic groups and labor unions. Community Services Inc. (CSI) is the general contractor and sales agent for the project. CSI was organized under New York's business corporation statute[7] and is a wholly owned subsidiary of UHF. Riverbay Corporation (Riverbay) is the cooperative housing corporation in which plaintiffs purchased shares, and which owns and operates the project. Riverbay was organized by UHF as a "mutual company" under New York's Mitchell-Lama Act,[8] and is named as a defendant here only to facilitate the derivative aspects of the action.

The individual defendants are officers or directors, or both, of some, and in some cases all, of the corporate defendants.

Pursuant to the Mitchell-Lama Act, the defendant New York State Housing Finance Agency (the Agency) provided the bulk of the financing for the project through long-term, low-interest mortgage loans; and the defendant New York State Division of Housing and Community Renewal (the State Division) is responsible for the supervision of the development, construction, promotion and operation of the project.

The question before this Court, raised by defendants' motion to dismiss for lack of subject matter jurisdiction,

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6. N.Y. Not-For-Profit Corporation Law (McKinney's Consol. Laws, c. 4, 1962).

7. N.Y. Business Corporations Law (McKinney's Consol. Laws, c. 35, 1962).

8. N.Y. Private Housing Finance Law §§10-37 (McKinney's Consol. Laws, c. 44B, 1962).

is narrow, but dispositive: *Is a "share" of a state-financed and supervised, nonprofit cooperative housing corporation a "security" within the meaning of the federal securities laws?*[9] If so, plaintiffs are properly in federal court; if not, each of the alleged bases for federal jurisdiction must fail, and with them, the pendent state claims.

[1] For the reasons set forth herein, this Court holds that the shares involved in this action are not "securities" within the meaning of the federal securities laws, and dismisses the complaint in its entirety pursuant to Fed.R. Civ.P. 12. Such ruling has no bearing on the merits of plaintiffs' grievances, which may well deserve to be fully aired in appropriate New York State forums.[10]

Background

Co-op City is no ordinary enterprise. Reputed to be the largest cooperative housing development in the United States, the project was conceived in 1964, completed in 1972, and presently houses some 45,000 people. The complex is located on a 200-acre site, includes more than 30 high-rise buildings and more than 230 townhouses, which in total provide about 15,400 apartment units ranging from three to seven rooms.

The project was facilitated by New York's salutary Mitchell-Lama Act, the express purpose of which is to ad-

9. Securities Exchange Act of 1934, 15 U.S.C. §78c(10); Securities Act of 1933, 15 U.S.C. §77b(1).

10. Shares of cooperative housing corporations are "securities" within the meaning and protection of New York's anti-fraud laws. N.Y. General Business Law, §352-e (McKinney Supp. 1972-73). *Cf.* People v. Cadplaz Sponsors, Inc., 69 Misc.2d 417, 330 N.Y.S.2d 430 (Sup.Ct.1972).

dress critical housing problems in New York's urban areas by encouraging private enterprise to participate with the state and municipalities[11] in the creation of nonprofit housing cooperative undertakings for persons with low incomes.[12] Toward that goal, the Agency is empowered to provide low-interest financing through the issuance of loans secured by first mortgages on the projects;[13] and tax ex-

11. The New York State Legislature, as part of the policies and purposes of the Mitchell-Lama Act has declared that

> [T]here exists in municipalities in this state a seriously inadequate supply of safe and sanitary dwelling . . . accommodations for families and persons of low income . . . that such conditions are due, in large measure, to overcrowding and concentration of the population, improper planning, excessive land coverage, lack of proper light, air and space, improper sanitary facilities and inadequate protection from fire hazards; that such conditions constitute an emergency and a grave menace to the health, safety, morals, welfare and comfort of citizens of this state, necessitating speedy relief which cannot readily be provided by the ordinary unaided operation of private enterprise and require that provisions be made by which private free enterprise may be encouraged to invest in companies regulated by law as to rents, profits, dividends and disposition of their property or franchises and engaged in providing such housing facilities and other facilities incidental or appurtenant thereto for families or persons of low income . . . N.Y. Private Housing Finance Law §11 (McKinney Supp. 1972-73).

12. As part of additional policy and purposes of the Mitchell-Lama Act, the New York State Legislature has found that

> [I]mprovement of the physical environment and revitalization of the quality of urban life . . . would be promoted by cooperative action by tenants who are persons or families of low income to acquire ownership of their dwellings and to operate them on a *nonprofit* basis; that such cooperative undertakings, with their consequent pride and responsibility of ownership would . . . lead to the stabilization and renewal of deteriorating neighborhoods. N.Y. Private Housing Finance Law §11-a(2-a) (McKinney Supp. 1972-73) (emphasis added).

13. N.Y. Private Housing Finance Law §§20, 22, 26, as amended (McKinney Supp. 1972-73).

emptions,[14] and certain other inducements are provided for corporate participants from the private sector.[15]

State regulation and supervision of the housing enterprises built under the Mitchell-Lama Act is mandated by law. The cooperative corporation cannot be created without the approval of the Commissioner of the State Division.[16] The statute mandates that no directors or subscribers to its stock may profit from the resale of such stock,[17] and provides that the tenant may not sublet at a price greater than approved by the Commissioner.[18] The statute requires the Commissioner's approval before the corporation can contract for operation of the project.[19]

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14. N.Y. Private Housing Finance Law §33, as amended, (McKinney Supp. 1972-73).

15. For instance, the acquisition of the property for a housing project pursuant to the Act declared to be necessary for the public purpose, and a municipality may take property by condemnation for the cooperative company. N.Y. Private Housing Finance Law §29, as amended, (McKinney Supp. 1972-73).

16. N.Y. Private Housing Finance Law §14 (McKinney 1962).

17. The statute requires that the certificate of incorporation for corporations such as Riverbay, shall state that

> [T]he company has been organized to serve a public purpose and that it shall be and remain subject to the supervision and control of the commissioner . . . that all real and personal property acquired by it, and all structures erected or rehabilitated by it, shall be deemed to be acquired, rehabilitated or created for the proper effectuation of the purposes of this article, and that the directors and subscribers of such company shall be deemed to have agreed that they shall at no time receive or accept from such company in repayment of their investment in its stock any sums in excess of the par value of the stock . . .

N.Y. Private Housing Law §13(13), as amended (McKinney Supp. 1972-73).

18. N.Y. Private Housing Finance Law §31(1)(a) (McKinney 1962).

19. N.Y. Private Housing Finance Law §27(4)(d) (McKinney 1962).

In fact, from the initiation of a project and continuing thereafter state control is pervasive.[20]

It is contemplated that a Mitchell-Lama cooperative project thus subsidized and supervised will be owned by a mutual company formed under the Act whose stock is held almost exclusively by persons who actually live in the project.[21] In accord with the purposes of the Act, the legislature has declared that no one may live in the project whose probable aggregate income exceeds six times the rental fees[22] and further, the legislature has indicated that preference shall go to the aged, the handicapped and to veterans.[23]

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20. The cooperative corporation cannot borrow or give security without the Commissioner's approval. N.Y. Private Housing Finance Law §20(1) (McKinney 1962); its capital structure is dictated by law and subject to the Commissioner's approval, Id. §21; the cooperative may not acquire real property, enter into any contract for construction or alteration of any real property, or sell any property, encumber or lease any real property, make any contracts for operation of the project, issue a guarantee of payment or enter into contracts for payment of salaries to officers or employees without the Commissioner's approval, Id. §§17, 27, 29. The Commissioner has the power to fix and to overrule the cooperative's rental structure, Id. §31(1); to investigate all aspects of the affairs of the cooperative and its dealings with others, Id. §32; and, in the event that the cooperative violates any provision of its certificate, or of law, or of the mortgage, or of any order of the Commissioner, the Commissioner has the power to remove all of the cooperative's directors and to replace them with his own designees, Id. §13(15)(c), and to commence an action in the Supreme Court of New York for the purpose of having such violations stopped and prevented, Id. §32(7), as amended, (McKinney Supp. 1972-73).

21. N.Y. Private Housing Finance Law §12(2-b), as amended (McKinney Supp. 1972-73).

22. N.Y. Private Housing Finance Law §31(2)(a), (b), as amended, (McKinney Supp. 1972-73).

23. N.Y. Private Housing Finance Law §§11, 31(7)(a), (b), as amended, (McKinney Supp. 1972-73).

Thus by definition, the tenants of Co-op City are persons of limited, and in some cases, fixed incomes. They secured their right to occupancy by completing a Subscription Agreement and Apartment Application form, wherein they agreed to subscribe to 18 shares of Riverbay common stock —at $25 par value per share—for each room in the apartment they selected. After their applications were screened and accepted by the State Division, they signed a three-year, non-proprietary Occupancy Agreement (lease), paid for or financed the purchase of their stock, and moved in as the buildings were completed and their apartments were ready for occupancy.

Beyond the face value of $25 per share and the right to occupancy, the Riverbay shares carry little, if any independent value or meaning. The Riverbay By-Laws provide that they may not be pledged or otherwise encumbered; the shares may descend intact, with the right to occupancy, only to a surviving spouse. The stock transaction is rescindable by either party. The shares may not be owned separate and apart from actual occupancy in Co-op City, and a tenant who wishes to move out—or who is forced out for violation of the lease, or because his income has increased beyond income limits—is required to divest himself of the stock. He must first offer the shares to the co-operative corporation for repurchase, and the By-Laws provide that he will be compensated for these shares with exactly the amount he paid for them. In the unlikely event that the corporation does not repurchase the shares,[24] only

24. Defendants have informed this Court that a reserve fund has been established for the repurchase of stock should drastic changes in economic conditions make it impossible to find buyers. The fund, as

[*footnote continued on next page*]

then is he free to sell the shares elsewhere and then the Mitchell-Lama Act provides that he may not sell them for more than the original purchase price, plus a fraction of the mortgage amortization which he has paid during his tenure at Co-op City.[25] It is implicit in the By-Laws and the Act that he may not sell to a person who does not meet the income and credit requirements for occupancy. Voting rights in the affairs of the cooperative corporation are not tied to the number of shares owned, which could vary greatly according to apartment size. Rather, to facilitate the democratic cooperative ideal, each apartment is allotted one vote.[26]

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of December 31, 1972, totalled $917,338. Further, they say, Riverbay will exercise its option to repurchase the shares without tapping the reserve fund as long as there is a waiting list for Co-op City apartments. They have represented that there are approximately 7,000 families on the waiting list, and that the annual turnover is about 300 families.

In a supplemental affidavit filed September 4, 1973, plaintiffs have called this Court's attention to recent Riverbay advertisements in local newspapers, reopening the application list for two and three bedroom apartments. This indicates, they assert, that the waiting list consists of a disproportionate number of applications for one bedroom apartments and that the 7,000 figure submitted by defendants may be a distortion. Without characterizing the figure one way or another, it is clear from plaintiffs' submission that if the waiting list for certain types of apartments is growing short, then Riverbay is actively seeking to rebalance it in order to remain in a position to continue to exercise its option without using reserve funds.

25. N.Y. Private Housing Finance Law §31-a (McKinney, Supp. 1972-73).

26. At the present time, the control of Co-op City is still in the hands of the original amalgam which conceived and built it, and the tenant/shareholders do not as yet actually possess the stock certificates they have purchased, nor will they have any voting voice in the affairs of Riverbay until they do receive the certificates. Riverbay's Subscription Agreement and Apartment Application provides that

[*footnote continued on next page*]

Appendix B

The obligations of the Co-op City residents flow from the lease, not the stock. In addition to the usual landlord/tenant covenants with respect to services and care of the premises, the lease provides that the resident's financial commitment is to pay annual carrying charges, prorated in advance monthly payments. The apportionment is not based on the number of shares owned, but rather on other factors such as size, type and location of apartment. This monthly payment is, for all practical purposes, rent. It represents a proportionate allocation of all the expenses of Riverbay in connection with the construction, ownership, maintenance, operations and activities associated with the housing corporation. These include such items as taxes, mortgage indebtedness, repairs, improvements and wages for Riverbay employees.

It is the amount of these carrying charges for Co-op City apartments which is the stress-point in this litigation.

In May of 1967, CSI as sales agent for Riverbay began promoting the sale of shares which carried with them the concomitant right to reside in Co-op City. Construction was then underway, but nowhere near completion. The Information Bulletin circulated through the mails to prospective tenant/stockholders set forth an estimated average monthly carrying charge of $23.02 per room. Thus, assuming he met the income eligibility requirements, the prospect for a three-room apartment could expect to pay about

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the stock shall not be distributed until such time as the Commissioner of the State Division issues a Certificate of Acceptability after the completion of the project. The Division apparently has the Certificate under advisement and it will be issued shortly, assuming that the project is found by the State Division to meet it standards.

$1,350 for stock in Riverbay and a monthly rent thereafter of $69.06. Persons familiar with the cost of housing in New York City can appreciate the incredible baragain Co-op City must have seemed to prospective tenant/stockholders. However, by the time the project was near completion, the bargain had somewhat diminished. In 1968, while the project was still under construction, the Information Bulletin estimate was revised to $25 per room, per month. Then in an unremitting upward spiral, the estimate was revised to $29.39 for 1970-72; to $35.27 for 1973-74; and it is now estimated that the charge will be $39.68 effective July 1, 1974. Thus, the $69.06 monthly rental bargain for a three-room apartment will soon cost $119.04 a month.[27] At the same time, of course, the maximum income eligibility limit, related as it is to carrying charges, has increased proportionately; and it may be assumed that to the extent the increases in carrying charges reflect the inflationary trend of the period, wages and salaries should have also risen proportionately. Thus, for tenants in the work force, it is possible that no real hardship has occurred.

But all of this is of little solace to the elderly and the handicapped, or anyone on a fixed or sluggish income,

27. Relatively speaking, Co-op City still offers one of the lowest rent structures of any Mitchell-Lama housing in New York City. This is due, at least in great part, to its low unit construction cost of $19,000 compared with the present Mitchell-Lama average of $40,000 per unit. In a case with similar underlying facts, commenced in the New York State courts, the estimated average monthly carrying charges had jumped from $51.35 per room in 1968 when the project was commenced, to $82.60 per room. People v. Cadplaz Sponsors, Inc., *supra*, note 10. It may be worth noting that the sponsors in that case were acquitted of criminal fraud charges in connection with the offering of stock in the cooperative corporation. N.Y. Times, July 10, 1973, p. 1, col. 1.

or indeed, anyone who arranged his affairs based on a belief that the earlier Co-op City estimates would remain unaffected by changes in the economy. The gravamen of the plaintiffs' complaint is that this is precisely what they were led to believe by misrepresentations and material omissions in the Information Bulletins. They point to the earliest Bulletin which indicated that there was a "lump sum" price of $258,678,000 fixed for the construction of the project, to be financed with a $250,000,000 mortgage from the Agency. The bulletin further stated that "the risk of completing the construction within the lump sum price is on the contractor." The final construction bill for Co-op City was $340,500,000, and the tenant/stockholders absorbed the impact, chiefly through a $125,000,000 increase in the mortgage loan from the Agency which consequently contributed greatly to the increase in carrying charges.[28] In addition to this alleged misrepresentation, plaintiffs assert that a number of other material facts were omitted from the Information Bulletins, all of which would have influenced their decision to purchase or not to purchase shares in the cooperative corporation.

28. Because of the procedural posture of the litigation the defendants have not as yet developed fully their side of the merits. However, it is well to point out here that other language in the Information Bulletins states that the lump sum price is subject to addition or deduction for change orders during the progress of the construction. Also, the Information Bulletins warn that "it is possible that increases in costs may increase the average monthly carrying charge somewhat above the [estimate]." Further, defendants argue that even if plaintiffs were misled, there could be no damages because under Riverbay By-Laws the tenant may withdraw from occupancy at any time and receive his stock purchase price back in full.

Appendix B

Since this Court is not called upon to rule on the merits here, and particularly in view of the conclusion this Court reaches as to this motion to dismiss, further detail with respect to the plaintiffs' specific charges or the defendants' answers would serve little purpose. But the Court is constrained to say that if ever there was a group of people who need and deserve full and careful disclosure in connection with proposals for the use of their funds, it is this type of group. By law, they would not be eligible for occupancy in Co-op City unless their financial resources were limited. The housing selection decision is a critical one in their lives. The cost of housing demands a good percentage of their incomes. Their savings are most likely to be minimal, and they probably don't have lawyers or accountants to guide them. Further, they are people likely to put a great deal of credence in statements made with respect to an offering by reputable civic groups and labor unions, particularly when the proposal is stamped with the imprimatur of the state.

However, the question before this Court is not whether the plaintiffs *should* be protected; rather, the question is whether or not they *are* protected by the federal securities laws.

The Legal Principles

Any analysis of this issue must begin with the language of the statutes which define the scope of the federal securities laws.

Section 3(a)(1) of the Securities Exchange Act of 1934 provides:

3. (a) When used in this title, unless the context otherwise requires—(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[29]

The Securities Act of 1933 contains a definition of a "security" almost identical to that contained in the 1934 Act, and the Supreme Court has indicated that the definitions under either Act are, for these purposes, interchangeable.[30]

Beyond the bare itemization contained in each definitional section, the statutes themselves yield little in the way of elaboration as to the characteristics of an instrument intended to be covered by the securities acts. Legislative history directly to the point is sparse and somewhat cir-

29. 15 U.S.C. §78c(10).

30. Tcherepnin v. Knight, 389 U.S. 332, 335-336, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967). See, S.Rep. 792, 73d Cong., 2d Sess. 14 (1934).

cular, confirming, for instance, that the definitional sections define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of security."[31]

However, there is a landmark Supreme Court case which sets forth a number of principles and tests which light this Court's way. The Court in S.E.C. v. Joiner Corp., 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943), did not attempt to rigidly classify the oil leases at issue there, rather it stated that the courts should construe the legislation in conformity with its dominating general purposes, *Id.* at 350-351, 64 S.Ct. 120 and decide whether these documents had the evils inherent in the securities transactions which it was the aim of the Securities Act to end. *Id.* at 349, 64 S.Ct. 120. Then, the Court went on to explain the definitional sections:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such a "transferable share," "investment contract," and "in general any interest or instrument commonly known as a "security." * * * Instruments may be included with any of these definitions, as matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace.

31. H.R.Rep.No.85, 73d Cong., 1st Sess. 11 (1933).

> Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'" *Id.* at 351, 64 S.Ct. at 124.

The Court then stated that the "test * * * is what character the instrument is given in commerce by the terms of the offer, the plan of distribution and the economic inducements held out to the prospect," *Id.* at 352-353, 64 S.Ct. at 124, noting that while in some cases a document might be proved a security by proving the document itself, "[i]n others proof must go outside the instrument itself. * * *" *Id.* at 355, 64 S.Ct. at 125.

In a later case, S.E.C. v. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946) the Court stated explicitly what was implicit in *Joiner,* that in searching for the meaning and scope of the word "security" in the securities laws, form should be disregarded for substance and the emphasis should be on economic reality. *Id.* at 298, 66 S.Ct. 1100. See also, Tcherepnin v. Knight, 389 U.S. 332, 336, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967).

The Riverbay Shares

What this means in the context of the Riverbay shares is that this Court must first determine whether or not the identifying characteristics of the Riverbay instruments, and the economic realities of the Riverbay transaction—the plan of distribution and the economic inducements held out

to the prospective purchasers—fit any of the items set forth in the statute; and, if not, then determine if Congress intended, nonetheless, to cover this type of transaction.

[2-5] Plaintiffs urge, in one branch of their argument, that inasmuch as "stock" is explicitly set forth as a "security" in the plain language of the statute, and the instruments purchased by the residents of Co-op City are called "shares of stock," they are, *a fortiori*, securities. They rely on the language set forth in S.E.C. v. Joiner Corp., *supra*, 320 U.S. at 351, 64 S.Ct. 120, where the Court notes that some instruments may be included as a matter of law if they answer to the name or description of a category in the securities law. Plaintiffs also cite the alternate holding in Tcherepnin v. Knight, *supra*, 389 U.S. at 339, 88 S.Ct. 548, which relies on the *Joiner* language to point out that the investment contract in *Tcherepnin* could have also qualified as "stock." This Court believes that a reading of the entire paragraph from *Joiner*, set forth in full, *supra*, along with the *Howey* refinement, makes it clear that this Court must, at a minimum, look through the name of an instrument to its essential characteristics and determine whether it fits the standardized, well-settled meaning of "stock." This is, in fact, what the Court did in *Tcherepnin*, and only after noting that the instrument was evidenced by a certificate and that payment of dividends were contingent upon an apportionment of profits did it identify the instrument as a "stock." Accepting the definition set forth in *Tcherepnin* as the well-settled meaning, it is clear that Riverbay shares do not fit because they do not represent any right to any apportionment of

tangible profits.[32] Therefore, this Court rejects plaintiffs' argument.[33]

[6-10] The Court in *Joiner* indicated that in cases where the instrument could not be proved a security on its face, "proof must go outside the instrument itself. * * *" S.E.C. v. Joiner Corp., *supra*, 320 U.S. at 355, at 125 of 64 S.Ct. Since this is the case here, the next area of inquiry

32. Plaintiffs also cite Movielab, Inc. v. Berkey Photo, Inc., 321 F.Supp. 806 (S.D.N.Y. 1970), aff'd. 452 F.2d 662 (2d Cir. 1971), where the district court, relying on the "plain meaning" principle of statutory interpretation, felt compelled to follow the "unequivocable and all embracing" statutory language that "[t]he term 'security' means any note . . . ." The Court of Appeals in affirming did not indicate that it felt bound by the name on the documents alone, but noted that the statutory language included "some notes at the very least" and held that the facts there presented brought those particular notes within ambit of the securities acts. Thus, with respect to the Riverbay "stocks" it is clear that the statutory language includes some "stock", but on these facts, not necessarily these "stocks." This Court has considered the decision in Stockton v. Lucas, 482 F.2d 979 (Em. App. 1973) wherein that court held that for purposes of the exemption from Phase I price controls, a share in a private New York City cooperative housing corporation was a "stock" within the definition developed under New York case law. That holding is not dispositive of the issue with respect to Riverbay shares for two reasons. First, federal law must govern on the question of whether shares constitute securities under the federal securities laws. Tcherepnin v. Knight, *supra*, 389 U.S. at 337-338, 88 S.Ct. 548. And second, the shares in *Stockton* were those of a private cooperative corporation, the shareholder had the right to retain the "stock" upon moving out, and thus the shares did, in fact, represent a right to the apportionment of the profits and the assets of the corporation.

33. The Court also rejects the defendants' argument that even if the plaintiffs' theory is valid, the "stock" in this case is not covered by the statute because the plaintiffs do not yet possess the certificates and, until the Commissioner of the State Division issues a Certificate of Acceptability, they are deemed to be neither stockholders or holders of any other equity obligation of the cooperative corporation. This is erroneous. The tenants of Co-op City have purchased, at the least, the right to own these shares, and that is enough under the statute, providing all other tests are met. 15 U.S.C. §78c(a)(13).

is into the substance of the transaction. It is to this area that the bulk of the arguments are directed.

Defendants urge first that the severe restrictions surrounding the owner's use of the stock are such that the shares fit none of the categories of instruments or transactions which Congress intended to be covered by the securities laws. Further they argue that the nonprofit economic realities surrounding it, and the public policy underlying it, coalesce to produce a unique transaction, far removed from the commercial world that Congress intended to regulate with the federal securities laws.

Plaintiffs contend that this Court, by applying some flexibility, could find that the major motivation for the purchase of Riverbay shares is the economic benefit to be gained and that such creates a securities transaction, if not as stock *qua* stock, then in some other form. Further they argue that the major thrust of Congress was to protect the investor and that it makes little difference whether or not the enterprise which induces him to part with his money is commercial or nonprofit.

For all the arguments set forth by both plaintiffs and defendants—technical, substantive, emotional, policy—it is well to note at the outset of this inquiry that it is the fundamental nonprofit nature of this transaction which in this Court's view is the insurmountable barrier to plaintiffs' claims in this federal court.[34]

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34. The remainder of defendants' arguments may carry some weight in the aggregate, but are not persuasive or dispositive standing alone. It makes little difference whether or not the purchasers' motive could be said to be speculative. Tcherepnin v. Knight, *supra*, 389 U.S. at 345, 88 S.Ct. 548; S. E. C. v. Howey, 328 U.S. 293, 301,

[*footnote continued on next page*]

[11] Plaintiffs attempt to overcome this hurdle by tacitly recognizing that if the Riverbay transaction is a securities transaction at all, it is more likely to be an investment contract than any other. An investment contract is one of the few items on the statutory list which has a developed definition. The oft-cited test enunciated in S.E.C. v. Howey Co., *supra*, has been used in a line of Supreme Court cases finding that such a contract does exist. See S.E.C. v. Variable Annuity Co., 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959); S.E.C. v. United Benefit Life Ins. Co., 387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967); Tcherep-

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66 S.Ct. 1100, 90 L.Ed. 1244 (1946). Nor is it dispositive that the shareholder is severely limited in his dealings with his shares, or that he must first offer them back to the cooperative. *Cf.* Affiliated Ute Citizens v. United States, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed 2d 741 (1972); Collins v. Rukin, 342 F.Supp. 1282 (D.Mass.1972). Federal securities regulation is not precluded just because the enterprise is regulated by state or other federal law. *Cf.* S. E. C. v. Variable Annuity Co., 359 U.S. 65, 75, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959); S. E. C. v. United Benefit Life Ins. Co., 387 U.S. 202, 210, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967); S. E. C. v. Lake Havasu Estates, 340 F.Supp. 1318, 1322-1323 (D.Minn.1972). Nor is it dispositive that the shareholder can, at his option, withdraw from the transaction and receive back his original investment, or that the value of the shares does not fluctuate. Tcherepnin v. Knight, *supra*, 389 U.S. at 345, 88 S.Ct. 548. Nor does the fact that the shareholder is not given certain rights normally attributed to his status, such as proportionate voting rights, determine the final result. *Cf.* Tcherepnin v. Knight, *supra* at 344, 88 S.Ct. 548.

And finally, this Court sees little value in engaging in the argument as to whether the right to occupancy is an incident of stock ownership, or whether the ownership of these shares is incident to the right to occupancy. Although it is clear that the securities laws do not extend to the classic purchase of real estate, this is so because the transaction does not meet the full test developed to identify a stock or an investment contract, not because the underlying property is real rather than personal. S. E. C. v. Joiner Corp., 320 U.S. 344, 352, 64 S.Ct. 120, 88 L.Ed. 88 (1943); Roe v. United States, 287 F.2d 435, 437-438 (5th Cir.), cert. denied, 368 U.S. 824, 82 S.Ct. 43, 7 L.Ed.2d 29 (1961).

nin v. Knight, *supra*. The *Howey* definition of an investment contract contains three elements. First, there must be a transaction whereby a person invests his money in a common enterprise; second, he must invest with the expectation of profits; and third, the profits must come solely from the efforts of the promoter or a third party. S.E.C. v. Howey Co., *supra*, 328 U.S. at 298-299, 66 S.Ct. 1100.

With respect to the Riverbay shares there can be no serious argument as to the first and last requirements. The first, a common enterprise, is self-evident because the corporation is a cooperative. The third could be questioned in a small cooperative where the ideal of joint venture was a reality, but given the massive size of Co-op City it would be specious to argue that the cooperative ideal precludes the notion of management by third parties. Furthermore, the By-Laws of Riverbay clearly vest absolute control in the hands of the promotors until the tenants receive their stock certificates. These have not yet been distributed, see note 33. Thus, at this time, the third element of the *Howey* test is met in fact, as well as in spirit.

It is on the second element—the expectation of profit—where plaintiffs' argument founders. *Joiner* instructs that this Court should look to the economic inducement offered by the promotor; *Howey* instructs that this Court should look go the expectation of the purchaser for profits. This Court has examined both and finds that none of the documents involved in this transaction—the Information Bulletins, the Subscription Agreement and Apartment Application, or the Occupancy Agreement—ever, once use material,

tangible profits as an inducement.[35] In fact, the Information Bulletins assert the contrary, impressing upon the potential purchaser the stability of environment to be achieved because the shares can not be used for speculation.[36] They also point out that a departing tenant is required to resell his shares to the corporation for no more and no less than the purchase price, thus assuring no gain and no loss.[37] Further, since these shares pay no dividends, contemplate no apportionment of any profits or assets or earnings of any kind, it is clear that the Co-op City residents did not purchase the shares with any expectation of profits, as the word is generally used in commerce. These shares are incapable—by law and by-law—of producing any monetary or fungible return. It would go against the funda-

35. The only conceivable tangible benefit mentioned is the possibility of city, state and federal tax deductions available as a result of the tenants' payment of real estate taxes through their carrying charges. To the extent that this can be characterized as economic inducement, it suffices to note that it is an incident of real estate ownership, not securities ownership. See Eckstein v. United States, 452 F.2d 1036 (Ct.Cl.1971).

36. The Information Bulletins stress the non-profit nature of the enterprise and the corporations sponsoring it. The advantages of cooperative organizations are set forth, in part, in the following terms:

> "[I]t is a way to obtain decent housing at a reasonable price" . . . "[It is] designed to provide a favorable environment for family and community living" . . . "[It avoids the problems of private apartment dwelling] where the landlord's interest was financial gain" . . . "Living in a cooperative is like living in a small town. As a rule there is very little turnover in a cooperative." "It is being a part of a group working for common purposes to benefit all."

37. The Information Bulletin recognized that "the investment a person makes in a cooperative often represents a large share of his life savings. To insure the investment against a time when there might not be an applicant for the apartment a special reserve will be established."

mental purpose of the cooperative ideal and the Mitchell-Lama Act if it were otherwise.[38] And, the state law is replete with provisions to guard against the possibility of profits from these shares or from occupancy in Co-op City.[39] Finally, of course, because both the cooperative corporation, Riverbay, and its sponsor UHF, are organized on nonprofit structures, there could be no monetary gain from the operations of the corporations to distribute, even if it were allowed by law.

Plaintiffs, fully cognizant of the legal problems, advance two bases upon which this Court might find the "profit" element satisfied in this transaction.[40] First, they suggest that this Court follow Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 13 Cal.Rptr. 186, 361 P.2d 906 (1961) and read the tangible profit motive out of the *Howey* test.[41]

The *Silver Hills* case has come to stand for the theory that the requisite profit motive should be replaced with a

38. The beneficial purposes of the Mitchell-Lama Act would be ill-served if a tenant whom the State Division has screened for income and credit stability was to be free to transfer his stock and its inherent right to reside in Co-op City to the highest bidder, or could in other ways manipulate his interest to produce a personal profit. See notes 11-12, *supra.*

39. See notes 15-25.

40. Plaintiffs put forth a third basis which relies on the remote possibility that there will come a time when the reserve fund (see note 24) may be depleted, and the divesting stockholder would be free to dispose of his shares on the open market, presumably at the small profit allowed by the Mitchell-Lama Act (see note 25). This Court does not find this remote possibility enough to establish a profit motive in the purchase of the Riverbay shares. Even if it should occur, the amount of profit allowed by the legislature is de minimis.

41. Several commentators would be in accord. See Anderson, Cooperative Apartments in Florida: A Legal Analysis, 12 Miami L.Rev. 13 (1957); Long, An Attempt to Return "Investment Con-

[*footnote continued on next page*]

"risk capital" approach which holds that the investor is protected by the securities laws if he risks capital, whether or not he expects a monetary return on the capital. In *Silver Hills* the risk was for a lifetime membership in a country club, but it was a large risk in a shaky enterprise devoted to making a profit. Given the pervasive state support and supervision of Riverbay in the transaction at issue here, and the resultant zero capital risk because of the guarantee of a complete refund on the stock purchase price, and the essentially nonprofit nature of the enterprise, this would not seem to be the case for the first federal application of this California state securities theory.

Alternatively, plaintiffs suggest that even though no monetary profit was envisioned or possible from the Riverbay shares, the shares were sold and purchased with economic benefits in mind. They ask this Court to expand the definition of "profit" to include savings of money that might have otherwise gone for more expensive housing; or the social gain to be had in quality housing for minimal expense. Put another way, the profit expected by Co-op City residents was the invaluable hedge against the skyrocketing real estate market in New York City.

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tracts" to the Mainstream of Securities Regulation, 24 Okla.L.Rev. 135 (1971); Zammit, Securities Law Aspects of Cooperative Housing, N.Y.L.J., Jan. 8, 1973, p. 1, col. 1; Note, Cooperative Housing Corporations and Federal Securities Laws, 71 Colum.L.Rev. 118 (1971); Note, The Economic Realities of a "Security": Is There a More Meaningful Formula, 18 Case W.Res. L.Rev. 367 (1967); Note, Cooperative Apartment Housing, 61 Harv.L.Rev. 1407 (1948); Comment, Sobieski, Securities Regulation in California: Recent Developments, 11 U.S.C.A.L.Rev. 1 (1963). But see, Miller, Cooperative Apartments: Real Estate or Securities, 45 Boston U.L.Rev. 465 (1965).

[12-14] This argument is most appealing to this Court, particularly when made on behalf of people with limited incomes who are not free economically to allocate a portion of their money to ordinary capital producing securities, however safe, and who are not in a position to risk their money in speculative schemes. But, of the few cases which counsel and this Court have managed to find where this concept of profit was a possible factor, only one on close analysis is near the point.[42] And its point, with respect to

42. Neither side has been able to cite to this Court any federal cases directly concerned with the narrow issue presented here. Plaintiffs have called this Court's attention to Davenport v. United States, 260 F.2d 591 (9th Cir. 1958), cert. denied, 359 U.S. 909, 79 S.Ct. 585, 3 L.Ed.2d 573 (1959), a criminal case where the court apparently accepted as a security, a share in an employment cooperative. But, the issue was not discussed or even raised in that case and this Court does not consider it authority on the question. This Court has found one other federal case, where the motivation of the purchaser was discussed in non-monetary terms. In S. E. C. v. American Foundation for Advanced Education of Arkansas, 222 F.Supp. 828 (W.D.La.1963), the transaction involved an annuity type scheme for a future education fund. The Court there said

> . . . the universal desire of parents to secure the advantages of higher education for their children and to offset whenever possible the increasing cost of such education, makes the application of the securities act emphatically necessary here. Id. at 831.

However, in spite of the court's language, the substance of the transaction promised the purchaser $6,000 worth of future education for a $1,000 investment. Thus underlying the decision was a monetary inducement and expectation.

Plaintiffs have cited, as authority for their position, Ashton v. Thornley Realty Co., 346 F.Supp. 1294 (S.D.N.Y.1972), aff'd without opinion, 471 F.2d 647 (2d Cir. 1973). There the district court granted summary judgment to a private cooperative corporation on a securities fraud complaint, implicitly accepting the stock involved as "securities," although the question was never raised or discussed. Whether or not this case stands for some authority on the general issue of the stock of a cooperative housing corporation as a "security," it is clear from the facts that it was not a state-supported and super-

[*footnote continued on next page*]

a medical cooperative, was simply, "money saved is money earned." State ex rel. Troy v. Lumberman's Clinic, 186 Wash. 384, 58 P.2d 812, 816 (1936). As attractive as that reasoning may be, Supreme Court cases and the lower federal court cases which follow them closely, and legislative documents concerning the federal securities laws convince this Court that the weight of authority is against it. This Court has attempted to follow the guiding principle that federal securities laws, as remedial legislation, must be read liberally to effectuate the purpose of Congress. Tcherepnin v. Knight, *supra*, 389 U.S. at 336, 88 S.Ct. 548, and is mindful that to further the objectives of Congress, the securities laws must be viewed as embodying a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits. S.E.C. v. Howey Co., *supra*, 328 U.S. at 299, 66 S.Ct. 1100. Yet, it seems certain that Congress never intended to stretch the scope of the securities acts outside the commercial world and its fungible valuables, to the uncharted and unchartable realm of intangible, elusive personal values where one man's balm may very well be another's bane.

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vised nonprofit corporation and that the possibility of monetary profit from sale of its stock was great. Therefore, it is not pertinent to the issues raised by the Riverbay stock.

Beyond these cases, every case cited by counsel for either side have involved only the general proposition that this Court should look through form to substance. In each there was no question but that the inducement was a monetary return; and in most the issue was the third-prong of the *Howey* test which is not at issue here. Therefore these cases are not helpful to determination of the specific question before this Court.

Appendix B

The legislative history of these acts, on the contrary, indicates that the intentions of Congress were focused on the powerful inducement of cold, hard cash and anything which could be converted to it through the commercial ingenuity of man. It is the abuse of this inducement, this motive, from which Congress believed investors needed protection, both for their well-being and for the health of the nation's commercial enterprises and its economy.[43]

43. This conclusion is based on the historical context of the legislation as a whole, but selected excerpts from Congressional documents serve to illustrate the point.
The House report on the Securities Act of 1933, describing the conditions which had precipitated the legislation, called attention to the "[a]lluring promises of *easy wealth* [which] were freely made with little or no attempt to bring to the investors' attention those facts essential to estimating the worth of any security." Then, referring to abuses in the real estate development field, the report condemned the ". . . creation of false and unbalanced values for properties whose *earnings* cannot conceivably support them." H.R.Rep.No.85, 73d Cong., 1st Sess. 2 (1933) (emphasis added). The report defines "securities" as the many types of instruments that *"in our commercial world"* fall with the ordinary concept of security. *Id.* at 11 (emphasis added).

The House report on Securities Exchange Act of 1934, states that

> The fundamental fact behind the necessity for this bill is that the *leaders of private business* . . . have not . . . been able to protect themselves by compelling a continuous and orderly program of *change in methods and standards of doing business* to match the degree to which the economic system has itself been constantly changing . . . changing in the proportion of the *wealth of the Nation invested in liquid corporate securities* . . .

H.R.Rep.No.1383, 73d Cong. 2d Sess. 3 (1934) (emphasis added). And the report continues with a discussion of the need for the legislation in terms of protecting the investor, increasing his confidence and thereby protecting the economy, and states that

> . . . *easy liquidity of the resources in which wealth is invested* is a danger rather than a prop to the stability of [the economic] system. *When everything everyone owns can be sold at once,* there must be confidence not to sell. . . . [A]s it becomes more liquid and complicated an economic system must become more moderate, more honest and more justifiably self-trusting.

Id. at 5 (emphasis added).

[15-17] Congress did not intend to sweep into the ambit of the federal securities laws, state-encouraged, nonprofit transactions made pursuant to a state emergency housing law and available only to state residents. And the mere fact that the state legislature chose to provide a form of organization common to the commercial world, in order to achieve critical public welfare goals, does not change that basic finding.[44] Clearly, the beneficiaries of the state legis-

44. It must be acknowledged that the exemptions from the registration provisions for charitable organizations in the 1933 Act, 15 U.S.C. §77c(4), and the 1934 Act. 15 U.S.C. §78*l*(g)(2)(D), plus the exemption for some cooperative associations in the latter, 15 U.S.C. §78*l*(g)(2)(E), (F), give some indication that Congress did not entirely ignore beneficial, nonprofit purposes in drafting the laws. However, the import of these exemptions is equivocal. It is settled that an exemption does not mean that the instrument or transaction or organization is exempt from the anti-fraud provisions of the Acts. 15 U.S.C. §77q(c); Tcherepnin v. Knight, *supra*, 389 U.S. at 342, 88 S.Ct. 548. But it is far from settled that a mere exemption indicates that Congress intended all instruments of the organizations exempted to be "securities" within the meaning of the Acts. Although the shares of a cooperative housing corporation are not included within the terms of any of these exemptions, plaintiffs attempt to make this technical argument, citing a Securities Exchange Commission (S.E.C.) Rule which does specifically exempt stock or other securities representing membership in any cooperative housing corporation with certain limiting provisos. Rule 235, 17 C.F.R. §230.235. Professor Loss characterizes this as "too facile" an argument. 1 Loss, Securities Regulation, 493-94 (1961). This Court agrees, given the vagaries of political and social pressures likely to work upon a legislative body drafting regulatory acts such as this. See, e.g., H.R.Rep. No.1418, 88th Cong. 2d Sess. 11 (1964), wherein it is indicated that the cooperative association exemption was included at the behest of rural electrification cooperatives. See also, Hearings on H.R. 6789, H.R. 6793, S. 1642. Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 88th Cong., 1st & 2d Sess., pt. 2, at 855-65 (1963-64).
Furthermore, this Court is, of course, not bound by any administrative determination of what is or is not a security, particularly when the Rule in question has never been tested in the courts and, as nearly

[*footnote continued on next page*]

lation should be protected from abuses, but it is this Court's view that in this instance, such protection must come from the state.

[18, 19] It is the plaintiffs' affirmative burden to show that their action has been properly brought in federal court. They have not met that burden with respect to this Court's jurisdiction under the federal securities laws. There being no other basis for federal jurisdiction, the counts of the amended complaint alleging violations of the federal securities laws are dismissed as to all defendants named therein. Further, since the federal securities allegations represent the only well-pleaded underlying basis for jurisdiction under the Civil Rights Act, count nine is dismissed as against the Agency. The remaining counts are dismissed as against the defendants named therein, inasmuch as they set forth pendent claims asserted pursuant to state law. United Mine Workers v. Gibbs, 383 U.S. 715, 726, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966). The complaint is therefore dismissed in its entirety for lack of subject matter jurisdiction.

So ordered.

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as this Court can determine, has not been rigidly enforced by the S. E. C. See, Zammit, Securities Law Aspects of Cooperative Housing, *supra*. Finally, a recent release indicates that the S. E. C. itself has refined its thinking and is now seeking to narrow its interpretation of the scope of the securities acts to those housing enterprises where all three-prongs of the *Howey* test are present. S.E.C. Release #5347, Jan. 4, 1973, Fed.Sec.L.Rep. ¶79, 163 (Trans.Binder 1972-73).

Appendix C

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the twelfth day of June one thousand nine hundred and seventy-four.

Present:

Hon. PAUL R. HAYS,
Hon. JAMES L. OAKES, Circuit Judges
Hon. A. SHERMAN CHRISTENSEN, District Judge

73-2613

Milton and Ellen Forman, Earle and Patricia McField, Michael and Phyllis Sicilian, Jack and Diane R. Blackin, Carl and Alma Trost, Robert and Pauline Carrington, Gilbert and Gloria Narins, Murray and Helene Victor, Jerome and Leonore Baer, Harold Asnin, Joseph S. and Wanda D. O'Connor, Abraham and Irene Kopolsky, Richard Ferguson, Hyman and Beatrice Fertel, Herman and Myra Ackerman, Bernard and Victoria Seinfeld, Frank and Hilda Glassman, Walter Simon, Thomas D. and Elsa A. MacLean, Melvyn and Gloria Plotzker, Fary and Charlotte Stern, Max and Bettina Schwarzhaupt, Herman B. and Rose Goldberg, Stephen and Juanita Reynolds, Arthur and Gertrude Lucker, Abraham and Henriette Schenck, Reginald and Zenobia Thomas, John Jr., and Elissa Pyatt, Albert L. and Rhoda Abrams, and Jack and Pearl Handschuh, individu-

[*title continued on next page*]

ally and on behalf of themselves and all others similarly situated, and in the right of Riverbay Corporation,

Plaintiffs-Appellants,

v.

Community Services, Inc., United Housing Foundation, The State of New York, The New York State Housing Finance Agency, Harold Ostroff, Robert Szold, Milton Altman, George Schecter, Anthony Marino, Paul Kramer, Irving Alter, Julius Goldberg and Riverbay Corporation,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York. and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is reversed and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court with costs to be taxed against the appellees.

A. Daniel Fusaro,
Clerk

By Vincent A. Carlin
Chief Deputy Clerk

Appendix D

Statutes, Rule, and Release Involved

The statutes involved in this case are 15 U.S.C. §77b(1), §77q, §77v(a), §78c(a)(10), §78j(b), and §78aa, which provide as follows, in pertinent part:

15 U.S.C. §77b

"When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

15 U.S.C. §77q

"(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission

to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section."

15 U.S.C. §77v(a)

"(a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took

place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts."

15 U.S.C. §78c(a) (10)

"(a) When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Appendix D.

15 U.S.C. §78j (b)

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

15 U.S.C. §78aa

"The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered

shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts."

17 C.F.R. §240.10b-5

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Securities Act Release No. 5347, January 4, 1973.

"The Securities and Exchange Commission today called attention to the applicability of the federal securities laws to the offer and sale of condominium units, or other units in a real estate development, coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser. The Commission noted that such offerings may involve the offering of a security in the form of an investment contract or a participation in a profit sharing arrangement within the meaning of the Securities Act of

1933 and the Securities Exchange Act of 1934.[1] Where this is the case any offering of any such securities must comply with the registration and prospectus delivery requirements of the Securities Act, unless an exemption therefrom is available, and must comply with the anti-fraud provisions of the Securities Act and the Securities Exchange Act and the regulations thereunder. In addition, persons engaged in the business of buying or selling investment contracts or participations in profit sharing agreements of this type as agents for others, or as principal for their own account, may be brokers or dealers within the meaning of the Securities Exchange Act, and therefore may be required to be registered as such with the Commission under the provisions of Section 15 of that Act.

The Commission is aware that there is uncertainty about when offerings of condominiums and other types of similar units may be considered to be offerings of securities that should be registered pursuant to the Securities Act. The purpose of this release is to alert persons engaged in the business of building and selling condominiums and similar types of real estate developments to their responsibilities under the Securities Act and to provide guidelines for a determination of when an offering of condominiums or other units may be viewed as an offering of securities. Resort condominiums are one of the more common interests in real estate the offer of which may involve an offering of securities. However, other types of units that are part of a development or project present analogous questions under the federal securities laws. Although this release

1. It should be noted that where an investment contract is present, it consists of the agreement offered and the condominium itself.

speaks in terms of condominiums, it applies to offerings of all types of units in real estate developments which have characteristics similar to those described herein.

The offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security. When the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present. The Supreme Court in *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U. S. 293 (1946) set forth what has become a generally accepted definition of an investment contract:

> "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." (298)

The *Howey* case involved the sale and operation of orange groves. The reasoning, however, is applicable to condominiums.

As the Court noted in *Howey*, substance should not be disregarded for form, and the fundamental statutory policy of affording broad protection to investors should be heeded. Recent interpretations have indicated that the expected return need not be *solely* from the efforts of others, as the holding in *Howey* appears to indicate.[2] For this reason,

2. *SEC* v. *Glenn W. Turner Enterprises, Inc.*, CCH FED. SEC. LAW REP. ¶93,605 (D.C. Ore. No. 72-390, May 25, 1972). See also *State* v. *Hawaii Market Center, Inc.*, 485 P. 2d 105 (1971) (cited in Securities Act Release No. 5211 (1971); and Securities Act Release No. 5018 (1969) regarding the applicability of the federal securities laws to the sale and distribution of whiskey warehouse receipts.

an investment contract may be present in situations where an investor is not wholly inactive, but even participates to a limited degree in the operations of the business. The "profits" that the purchaser is led to expect may consist of revenues received from rental of the unit; these revenues and any tax benefits resulting from rental of the unit are the economic inducements held out to the purchaser.

The existence of various kinds of collateral arrangements may cause an offering of condominium units to involve an offering of investment contracts or interests in a profit sharing agreement. The presence of such arrangements indicates that the offeror is offering an opportunity through which the purchaser may earn a return on his investment through the managerial efforts of the promoters or a third party in their operation of the enterprise.

For example, some public offerings of condominium units involve rental pool arrangements. Typically, the rental pool is a device whereby the promoter or a third party undertakes to rent the unit on behalf of the actual owner during that period of time when the unit is not in use by the owner. The rents received and the expenses attributable to rental of all the units in the project are combined and the individual owner receives a ratable share of the rental proceeds regardless of whether his individual unit was actually rented. The offer of the unit together with the offer of an opportunity to participate in such a rental pool involves the offer of investment contracts which must be registered unless an exemption is available.

Also, the condominium units may be offered with a contract or agreement that places restrictions, such as re-

quired use of an exclusive rental agent or limitations on the period of time the owner may occupy the unit, on the purchaser's occupancy or rental of the property purchased. Such restrictions suggest that the purchaser is in fact investing in a business enterprise, the return from which will be substantially dependent on the success of the managerial efforts of other persons. In such cases, registration of the resulting investment contract would be required.

In any situation where collateral arrangements are coupled with the offering of condominiums, whether or not specifically of the types discussed above, the manner of offering and economic inducements held out to the prospective purchaser play an important role in determining whether the offerings involve securities. In this connection, see *Securities and Exchange Commission v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943). In *Joiner*, the Supreme Court also noted that:

> "In enforcement of [the Securities Act], it is not inappropriate that promoters' offerings be judged as being what they were represented to be." (353)

In other words, condominiums, coupled with a rental arrangement, will be deemed to be securities if they are offered and sold through advertising, sales literature, promotional schemes or oral representations which emphasize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, in renting the units.

In summary, the offering of condominium units in conjunction with any one of the following will cause the offer-

ing to be viewed as an offering of securities in the form of investment contracts:

1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.

2. The offering of participation in a rental pool arrangement; and

3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

In all of the above situations, investor protection requires the application of the federal securities laws.

If the condominiums are not offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of others, and assuming that no plan to avoid the registration requirements of the Securities Act is involved, an owner of a condominium unit may, after purchasing his unit, enter into a non-pooled rental arrangement with an agent not designated or required to be used as a condition to the purchase, whether or not such agent is affiliated with the offeror, without causing a sale of a security to be involved in the sale of the

unit. Further a continuing affiliation between the developers or promoters of a project and the project by reason of maintenance arrangements does not make the unit a security.

In situations where commercial facilities are a part of the common elements of a residential project, no registration would be required under the investment contract theory where (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit.

The Commission recognizes the need for a degree of certainty in the real estate offering area and believes that the above guidelines will be helpful in assisting persons to comply with the securities laws. It is difficult, however, to anticipate the variety of arrangements that may accompany the offering of condominium projects. The Commission, therefore, would like to remind those engaged in the offering of condominiums or other interests in real estate with similar features that there may be situations, not referred to in this release, in which the offering of the interests constitutes an offering of securities. Whether an offering of securities is involved necessarily depends on the facts and circumstances of each particular case. The staff of the Commission will be available to respond to written inquiries on such matters.

By the Commission."